VERSAILLES SUMMIT AND THE WORLD ECONOMY: HIGH INTEREST RATES AND PROTECTIONISM

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VERSAILLES SUMMIT AND THE WORLD ECONOMY: HIGH INTEREST RATES AND PROTECTIONISM

TUESDAY, MAY 25, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2167, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Hamilton, and Richmond.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; and Kent H. Hughes, Marian Malashevich, and Sandy Masur, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for the start of its hearings on U.S. international economic relations.

The prosperity of the international economy continues to depend, despite all of the changes in world conditions over 40 years, on the wisdom and soundness of U.S. economic policy. That is precisely what will be called into question early next month when the President meets with the leaders of our allies at the Versailles summit.

The effects of U.S. deficits and high interest rates on the strained economics of our principal allies and on the developing world will be the No. 1 item on the agenda at Versailles. And there will not be a single nation at that table in Versailles which will offer unqualified support for the policies of the Reagan administration.

Since the Reagan administration took office, our economic policy has aggravated the difficulties faced by other countries of the world. Fiscal policy has been loose, as cuts in social programs designed to help the poor have been overwhelmed by unprecedented tax cuts and huge increases in military spending. The result is an enormous Federal deficit which will only get worse in the years ahead. In addition, our high interest rates muddle results from our supertight monetary policy.

The effects of our deficits and interest rates on our major trading partners are profound. European countries are still struggling to pull themselves out of recession, a recession which has brought disturbingly high unemployment rates. High real U.S. interest rates, which act to force comparable rates abroad, are a major factor preventing recovery. They choke off the domestic investment needed to pull out of the recession. At the same time, our high interest rates are causing exchange market instability and adding to the uncertainties of an already difficult economic environment.

Our recession, coupled with high interest rates, also is having deleterious effects on developing countries. Recession here and in Europe deprives developing countries of crucial export markets. And high interest rates compound the problem by exacerbating an already precarious debt situation.

Our three witnesses today have been asked to address the effects of U.S. economic policies on the global economy. They are: Richard Cooper, professor of economics at Harvard, and former Under Secretary of State for Economic Affairs in the last administration; John Norris of Chase Econometrics; and Myer Rashish, an economic consultant, and until recently, Under Secretary for Economic Affairs and intimately involved in preparations for last year's summit.

Gentlemen, we are delighted to have you here. Under the rule and without objection, your prepared statements will be received in full and printed in the hearing record.

Before proceeding, at Senator Paula Hawkins' request, her written opening statement will be placed in the hearing record at this point.

[The written opening statement of Senator Hawkins follows:]

WRITTEN OPENING STATEMENT OF SENATOR HAWKINS

I wish to thank the Chairman for convening this series of hearings on the Versailles Economic Summit. International monetary and trade pressures threaten to disrupt irrevocably the good relations between the major nations of the world, and today it is more important than ever that we keep channels of communication open through such mechanisms as the Summit.

Participants in June's meetings will have a full plate of difficult issues before them. Interest rate, currency valuation and worldwide employment problems loom large. Trade measures, particularly those of Japan, deeply concern us as a Nation and my own State of Florida. For years, we have sought free and fair access to the Japanese market for citrus, and I believe we should use every opportunity—including Summits—to press for greater sales opportunities.

I will be especially concerned, however, with Summit discussions regarding our relations with developing countries. At last count, the external debt held by those nations topped $350 billion, while the relative prices for their raw material and commodity exports had declined precipitously. Summit participants can therefore be expected to face new demands for multilateral lending, debt rescheduling and more preferential trade treatment. How we respond to those challenges may well determine the course for worldwide development over the next decade.

I believe one of the best ways to handle developing, as well as developed, country economic problems is through expanded private sector participation in the mechanisms for growth. A good example of this is the President's Caribbean Basin Initiative, which uses private enterprise as the engine for economic development. With the CBI's package of trade, aid and investment incentives, we can help that region to build industries and infrastructure, to dismantle injurious import barriers, and to stem the emigration of real and potential human talent. The short-term costs to the U.S. Treasury in import duties and tax revenues foregone are indeed worth the price of long-term economic and political stability for our neighbors to the south.

I would therefore hope President Reagan would use the opportunity afforded by the Summit to gain strong support for our Caribbean initiative.

Representative REUSS. Mr. Rashish, why don't you start out, sir.

However, during an early part of your testimony I am going to have to excuse myself for a moment to answer a floor call, but I'll be right back, so if you will just start, or if you will just rest for a moment I'll be back in about 6 minutes.

[A short recess was taken.]

Representative REUSS. The committee will be in order.

Thank you all for waiting while I cast a vital policy floor vote.

I'd now like to hear from Mr. Rashish.

STATEMENT OF MYER RASHISH, ECONOMIC CONSULTANT, WASHINGTON, D.C., AND FORMER UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. RASHISH. Mr. Chairman, I was musing in the hiatus about a Viennese joke that is attributable to Sigmund Freud about the intellectual who was challenged to a duel in a cafe by a nobleman for some presumed slight. He was instructed to show up with seconds on the field of honor at the break of dawn.

The next morning the nobleman with an entourage arrived at the field of honor at the appointed time. The nobleman waited 15 minutes, a half-hour, 45 minutes. Presently a messenger came running breathlessly with a note from the intellectual which read as follows: "Have been unavoidably detained. Do not hesitate to start without me." [Laughter.]

Representative REUSS. Anybody who can pronounce Freud can pronounce Reuss.

Mr. RASHISH. They have an "oy" in common.

Mr. Chairman, the Japanese have a saying that there are two kinds of fools in the world: those who have never climbed Mount Fugi and those who have climbed Mount Fugi twice. That is too cynical an evaluation of summits, but it does suggest that summitry is an exercise that should be undertaken prudently with considerable preparation and great care.

The Versailles summit is the eighth summit of the heads of state and government of the leading industrialized countries of the free world, the first having taken place at Rambouillet in France in 1975.

Mr. Chairman, I do not have a prepared statement, but I have an outline. A little over 10 years ago I was a consultant to this committee, actually to the Subcommittee on International Economic Policy, of which my friend Hale Boggs was chairman, and I organized some meetings on foreign economic policy to which were invited a number of people from various parts of the world. One of these arrived, contrary to instructions, without a prepared statement, and when Hale asked him why he did not bring a prepared statement he said he was one of those people who didn't know what he thought until he heard what he said.

I have at least gone to the point of preparing a brief outline.

The central thesis of what I am about to say is I think summits are very important exercises in statecraft, if only because they engage the attention, the efforts, and the prestige of the leaders of the major countries in terms of economic weight in the world. The seven summit countries between them account for half of the gross product of the world and half of the world trade.

Summits are also occasions at which important things can take place. I say "can." It is not clear that they always have produced results of consequence. But they do have that potential, again because they involve concentration of mind and effort of the most important leaders of the world scene.

The summit won't take place until the beginning of the evening of June 4 at Versailles, and I will address this in a little more detail later on, but my own prediction is that the Versailles summit will present an opportunity to bring some very greatly needed focusing of national policies on the part of the seven summit countries. But I also, on the

basis of what I have been told and what I have been reading, have the impression that the Versailles summit will in fact fall considerably short of achieving that goal. So in some respects it will be an opportunity that will be missed.

Summits are important because they are, in fact, instruments of alliance policy. They deal principally with economic issues. There are, of course, informal bilateral discussions in which a whole array of issues—political, strategic, security, as well as economic—are discussed among the leaders. But the convention has been—and it's been insisted upon by all the leaders—that the economic summits principally address an economic agenda. But economics, certainly in this day and age, is, after all, politics.

INTERDEPENDENCE OF DOMESTIC AND INTERNATIONAL ECONOMIC POLICY MAKES SUMMITRY AN IMPORTANT PROCESS

The growing interdependence of the economies of the industrialized countries, the growing vulnerability and exposure to events that take place outside the ambit of these seven countries, the fact that more and more, it seems to me, the stuff of foreign policy has to do with economic issues, and beyond that the fact, it seems to me further, of the inability to distinguish clearly, as we once thought we could, between domestic economic policy and international economic policy, even for a country of the scale and relative insularity of the United States—all these factors, it seems to me, underline the importance of economic policy as an issue in politics and in foreign policy.

So in this interdependent, interpenetrated, and vulnerable world in which all these seven countries live, the summit becomes an instrument for managing that interdependence, provides an opportunity for heads of states who are, after all, politicians, to meet each other to get a sense of each other. It offers an opportunity, if not to arrive at concrete and highly specific conclusions—it at least offers an opportunity to these seven leaders to arrive at some general consensus that will affect their policies in the months and years ahead.

The summit process, it seems to me, may be as important as the event itself. To paraphrase Mr. McLuhan's "The Medium is the Message," I would argue that "the process is the result." That is to say, the preparatory process, which consists of the meetings of the personal representatives, the various events that constitute the runup to the summit—most recently the ministerial meeting of OECD; the interim committee meeting of the IMF; and a very new event, the quadripartite trade consultation group that Ambassador Brock has convened which met recently and consists of the United States and European community, Japan, and Canada—are the preparatory events or parts of this process leading up to the summit. It is, in fact, what makes the summit work and offers the prospect that if the summit arrives at some consensus or some agreements they will have some effect later on.

Now, summitry, if it is to be effective, is based on certain principles and assumptions.

There is an assumption that there are common interests and goals that are discernible to all of the seven countries that participate in the summit.

There is an implied assumption that in trying to achieve or trying to give effect to these common interests and realize these common goals, the individual members of the summit countries are prepared to accept some external constraints on their domestic policies, that there is a kind of international discipline that is at work and that this kind of discipline and these kinds of constraints may require some adjustment of national policy, at least at the margin.

And it seems to me a very dominant principle that has to do with summitry, as well as with a number of other aspects of international instruments for international cooperation, a very important principle, is the dominant weight of the United States, constituting, as it does, half the gross product of the summit countries, which requires that the United States exercise leadership in the process.

I am persuaded that without the exercise of that leadership, direction, and initiative, the summit process will not work.

The setting for Versailles is not a particularly propitious one. In the larger political and strategic sense the alliance is suffering from some disarray. I know it is conventional to say that the alliance has always suffered from disarray. I discern myself a certain qualitative change in this disarray which is very disturbing and unsettling. There has been a change in the relative power balance among the summit countries; there has been a pronounced shift in the balance of strategic power between the United States and the U.S.S.R.; and we have perceived some real shifts in economic power between the OECD countries and the newly industrialized countries of which, curiously, Japan seems to be a kind of paradigm.

Europe itself is suffering from internal tensions, pressures on the European monetary system, and the most recent difficulties which the Community has had with respect to agriculture.

The world economy generally is marked by unemployment, extraordinarily high real interest rates, volatile exchange rates, pressures for trade protectionism, and so on.

The larger political strategic disarray or uncertainty is likely to manifest itself most acutely with respect to one of the agenda items on the summit agenda, and that is the issue of the East-West economic relations.

Beyond the conventional array of issues which will be discussed, such as macroeconomic issues, exchange, and interest rates, trade, and energy, and I might add as a footnote it is remarkable how constant the agenda of summits has been in the 7 years of their history. Beyond these, a relatively new issue was supposed to have had pride of place at the Ottawa summit, by virtue of the fact that the summit before Ottawa, the Venice summit, instructed the seven to address this issue, and that was the so-called North-South dialog or relations between the industrialized and developing countries.

My own view is very little is likely to emerge from discussion of North-South issues at Versailles, largely because we missed an opportunity at Cancun to put the North-South dialog on a surer footing. Instead, the dialog snapped back into the General Assembly of the United Nations, where it has languished and produced no results. We are now back in that venue which offers uncommon hospitality for political rhetoric but offers very little prospect for real achievement in enhancing the development of the less-developed countries.

So, Versailles comes at a rather bad time in terms of the world economic situation, as well as the larger political, strategic atmosphere. There is some question on the part of our summit partners as to the vigor, direction, and purpose of the U.S. leadership, and some question on our part as to whether the governments of Europe are strong enough to respond to leadership even if it were forthcoming.

Now, in the ideal world, what ought to be done at Versailles?

Despite this disarray—it may be too strong a word—in the alliance, it does seem to me that there is, in the economic area—maybe that's the wisdom of having economic summits—a greater range of commonality of purpose and interest than there is in other areas.

This commonality of interest, it seems to me, created a condition in which it would have been possible—a possibility that I think may not be realized—to effect a transaction at the Versailles summit that would have, I think, improved the condition and prospects of the summit countries and the rest of the world.

Without going into great detail, it seems to me—and it is a view that I have held for many months—the kind of a deal that was in order for the Versailles summit and was feasible involved a trilateral compact between the United States, Europe, and Japan.

In the case of the United States, given the economic weight we have, we should have come forward with a proposal that would have involved what is by now some very conventional wisdom, so conventional that five former Secretaries of the Treasury proposed it yesterday, and that is a change in the policy mix in the United States, a tighter fiscal policy and easier monetary policy.

This is what our European allies in the summit have been pleading for for many months. It is what, in a somewhat awkward fashion, is being negotiated out between the Congress and the executive over the past few weeks. Had the President, in the exercise of his foreign policy leadership and in response to the need to bring some equilibrium in the world economy, taken the initiative on both foreign policy and domestic economic policy grounds to effect that kind of change, he both would have served his domestic economic purposes and his foreign policy purposes more efficiently.

I would see further that it would have been possible, as part of this transaction, given the interest that the Europeans have in this kind of readjustment of American policy, to have persuaded the Europeans to come with a more, in my view, constructive and cooperative approach on this use of East-West economic relations, an issue which I think predictably now is not going to be resolved in any significant way at the summit.

And finally, Japan, as its component in this transaction—and this is, I suppose, something worth more discussion and certainly more thought than I have given to it—might have effected a comparable but opposite change in its policy mix. The most important contribution that Japan might make to world market equilibrium would have required some fundamental change in Japan's domestic economic policies, but Japan's quid pro quo would have been the kind of trade declaration at the summit that looked forward to a positive and explicit agenda for the GATT ministerial meeting in November. There is some question now as to how far the summit countries are prepared to go in committing themselves to such an agenda at Versailles.

This is, it seems to me, the core of the deal or the transaction that might have taken place at Versailles. It doesn't seem to me it's going to take place.

What will take place at Versailles will be much more marginal, much more incremental and modest.

Now, it has to be understood that when the leaders of the seven major industrialized countries of the world convene at any meeting, that meeting is condemned to success. It is inappropriate, unacceptable, that a summit be seen as a failure. But the success may in reality be a modest one indeed.

On the larger macroeconomic issues, which subsume exchange and interest rate questions, from what I read in the press, there will be a channeling of this off to a different forum, the IMF, where there will be a year-long study of the question of the relationship between domestic economic policies, how they should be made convergent, and what the relationship of those convergent policies might be to the behavior of exchange rates.

On technology, which is a subject which the French Government has taken the initiative to put on the agenda at the Versailles summit, my suspicion is that that is not sufficiently far advanced to produce any results at Versailles but could be the basis of some kind of wisemen's study.

On trade, my impression is that while the commitment to fighting protectionism will be repeated in this summit, as it has in virtually every summit, the positive commitment to a substantial and meaningful GATT ministerial agenda may not be forthcoming.

On East-West, I have already indicated I think that very little is likely to emerge from the summit on this issue. The questions of credits to the U.S.S.R., the Siberian natural gas pipeline, and COCOM review will just sort of drag on as they have.

And on the North-South issue, minds will be concentrated once again on the unsuccessful attempt of the last session of the General Assembly to arrive at a resolution or declaration on global negotiations, an enterprise which at best is of minor consequence to the real world.

While I think, therefore, that the Versailles summit is likely to, as the academics say, suboptimize, produce less than it might otherwise have produced, particularly at a time when the world economy is going through an extremely difficult passage, nonetheless I remain committed to the proposition that if we did not have this summit, if it were not a regular feature of the landscape, things would be a good deal worse than they are.

Thank you, Mr. Chairman.

MEAGER RESULTS AT VERSAILLES

Representative Reuss. You envisage a suboptimum result. I would call it a dud from your ticking off the problems presented and the results achieved—no change in the U.S. policy mix, no change in the Japanese policy mix, no East-West agreement, platitudes on trade, and North-South.

While I agree with you it's better to meet and talk than never to meet at all, it really is disappointing to me to hear someone who is sensing what is going to happen, I think about as good as anyone, give this gloomy prognosis.

A year ago, a few weeks before the Ottawa summit, one sensed that the Europeans, at least, and the Canadians, were breathing fire and were going to come to Ottawa saying to the United States, "Please change your policy mix; cut down on the future deficits, which means you will have to cut down a bit on your military build-up and your tax concessions, and let's have a little less draconian monetary policy."

That is what they were all hinting at a few weeks before the summit, but they certainly went soft at the summit. There never was heard a discouraging word, at least in public.

My question is, Do you think they are going to be as polite this time?

Mr. RASHISH. Yes. I don't think that they are any less concerned. They may indeed be more concerned, but I think the nature of the summit is such that it tends to induce that, and also because much of the steam has been vented already in these other preliminary fora, the OECD ministerial, the IMF, and so on.

I think their concerns and anxieties may be more deep seated. At Ottawa, after all, four of the summit leaders were brand new. Now they have all been in office 1 year. It is their second summit.

Second, President Reagan had been in office only a relatively short period.

While there was concern about the course of U.S. policy—and indeed concern on our part about policy that some of the other summit countries were following, although the weight of the United States gives our policy an immense importance that cannot be assigned to others—there was also the willingness to exercise some patience, to give it time.

Representative REUSS. If I could interrupt, I recognize that, and that is an explanation of why things were fairly flaccid in Ottawa. But now Reaganomics has had a year to prove its mettle and the newcomers have gotten their sea legs a bit. Therefore, I am interested in your saying that you expect the Europeans to be as flaccid at this time as they were a year ago.

Mr. RASHISH. I don't think as flaccid. First of all, I don't think it's fair to ascribe the Europeans with the same animus toward Reaganomics which I take it you harbor in your breast, Mr. Chairman. They have a concern about some of the aspects of U.S. policy, notably the high real rates of interest as well as the volatility, and some concern about the path of exchange rates.

The reason why those issues will not be the occasion for great contention at Versailles is because it has now been agreed to set those issues aside in recognition of the fact that they cannot be resolved, that they would in fact be the focus of contention and strife if they were to be addressed at the summit.

Representative REUSS. I wasn't really aware that they had been pigeonholed. Who did that, and in what document?

EXCHANGE RATE POLICY TO BE REVIEWED

Mr. RASHISH. As Will Rogers once said, "All I know is what I read in the papers," and what the papers tell me is it was precooked at the OECD ministerial and the IMF Interim Committee meeting at the initiative of the United States, I think the Treasury Department, that it would be appropriate to have the issue of exchange rate volatility,

which in turn is a function of the divergence or convergence of policies followed by the summit countries—this set of issues—it would be appropriate to have this set of questions examined and studied objectively.

As I understand, from what I read in the papers, the IMF, after the study is completed, will report back to the summit meeting next year, which, incidentally, will be held in the United States.

Representative REUSS. If I could pursue this for a moment. If I were an European or a Japanese, I wouldn't feel that this alleged agreement to have the IMF look at volatile exchange rates precluded my discussing the mishmash of U.S. fiscal and monetary policies, because our too loose fiscal policy and too tight monetary policy saps our summit neighbors, not just in exchange rates but by exporting unemployment. And so they can make obeisance to the pigeonholing in the IMF of the exchange rate aspects and still get in some pretty good licks on other equally important aspects, and specifically request us to change our mix. Everybody talks about it. It seems to be a little ridiculous to convene a summit at which nobody talks about the real issue.

U.S. MACRO-ECONOMIC POLICIES WILL NOT DOMINATE SUMMIT

Mr. RASHISH. What I'm saying is my expectation—and it is only a prediction—is that while surely the subject will be discussed, it won't enjoy the kind of pride of place, it won't be the focus of the discussions, as was the case at Ottawa.

In Ottawa, as I have already said, while those issues enjoyed priority attention, there was a willingness to wait and see. The issues were not really forced. Besides which, there is no point in that setting to get excessively nasty about these things. There is a premium on civility.

But now we have had a year of experience, and the problems seem to have become exacerbated rather than easier. The feeling is, I take it, that the possibility of forcing something at this summit is not very great. Instead of having the central issue at the summit be one in which it was fruitless to engage in a fight over, why not divert the issue into a more benign and pacific channel, relieve the pressure of the steam, so to speak, before you actually go to the summit meeting?

CHANGE IN ADMINISTRATION RHETORIC

I think it is interesting that in the runup to the summit, the Secretary of the Treasury and his colleagues have indicated at least a difference in rhetorical tone in their comments about exchange market policy.

Representative REUSS. You mean by our Secretary of the Treasury saying that we might forsake our nonintervention exchange rate policy and do a little churning of the portfolio?

Mr. RASHISH. Yes. In contrast to the kind of rhetoric, the kind of statements that have been made recurringly over the last year or so about that subject, in the immediate runup to the summit the Secretary of the Treasury took a more supple position, that is to say, "This is worth looking at; perhaps we really ought to examine this a

little bit more closely." It wasn't a categorical, inflexible rhetorical position. I regard that as a positive development.

Representative REUSS. As a veteran of inter- as well as intradepartmental affairs, what do you imagine that new initiative by the Secretary of the Treasury will do to the Treasury hierarchy internally and specifically Under Secretary Sprinkel?

Mr. RASHISH. I have no idea, and if I did I wouldn't comment, Mr. Chairman.

Representative REUSS. I was so fascinated by your presentation that I started a few preliminary questions, and I will cease because we want to hear from the others. But I certainly want Congressmen Richmond and Hamilton to have an opportunity now to ask questions.

Representative RICHMOND. Yes, Mr. Chairman.

WILL THE WEST BENEFIT FROM THE SOVIET GAS PIPELINE OR BECOME TOO VULNERABLE?

Mr. Rashish, one of the issues of concern to me about this Versailles conference is the issue of the natural gas pipeline to the West. I feel that it is probably the most brilliant stroke of economic planning to allow the pipeline to be built. It allows the Western powers to generate $5 billion worth of hard goods, which we will then sell to the Russians. And if the Western powers want the gas, they can take it; if they don't want the gas, they don't have to take it.

So I think everything is in favor of the Western powers urging the Russians to build this pipeline. It is virtually a one-way deal. Yet, our Government hierarchy is against it, and it just boggles my mind. As a businessman and a politician, it seems to me the greatest thing we could have is a $5 billion pipeline connecting Russia to Western Europe with natural gas which they may or may not take.

Now, will you please tell me why our Government has this insane policy? I'll bet it's not yours.

Mr. RASHISH. Yes, it is mine. I regard the policy as, on the whole, quite sane. But while I think the policy generally is quite sane, I'm not sure we are working toward the right solution to the problem.

I think it's crazy to give the Russians—it isn't $5 billion; it's a lot more than that.

Representative RICHMOND. How much?

Mr. RASHISH. $10 or $15 billion.

Representative RICHMOND. $10 or $15 billion worth of hard goods——

Mr. RASHISH. I think it's crazy to give the Russians $10 or $15 billion of hard goods at subsidized interest rates in order to produce more employment in the steel fabricating industry in France and Germany. It seems to me if you are willing to spend that kind of money, there are better ways to encourage——

Representative RICHMOND. I don't want to interrupt you, but it also involves the use of a lot of American—General Electric and Westinghouse would——

Mr. RASHISH. Not under the embargo that was put into effect after martial law was declared in Poland December 13.

Representative RICHMOND. I say, if you were to take a more realistic

attitude toward this pipeline and realize $15 billion worth of Russian gold we could possibly pick up, and Western Europe and the United States were building this pipeline, and obviously a pipeline is totally worthless unless you buy the gas—it seems to me it's a wonderful deal for the Western powers.

Mr. RASHISH. Well, I don't think it's a wonderful deal for lots of reasons. I don't think it makes good economic sense. If you are trying to solve unemployment problems, it's a hell of a way to solve unemployment problems.

Second, concerning the countries—and only two have signed up at the moment, West Germany and France—the consuming countries of Western Europe did not examine carefully enough the vulnerability aspects of the pipeline, the alternative sources of natural gas available to them, primarily from the North Sea, and so on. They did not examine carefully the implications of having a flow of hard currency earnings for the Soviet Union in the neighborhood of $10 million a year while the gas was flowing.

But this is a long subject which could consume the whole morning and afternoon. Let me just make the observation that the kind of policy that I would like to see emerge on the question of the pipeline, in the light of all these considerations of vulnerability—foreign exchange earnings for the Soviet Union—is a policy inspired by a concern for energy security. The kind of policy I would like to see is one in which the summit countries, the Western allies generally, put together an agreed strategy for natural gas supply and security which would exploit other sources of natural gas—the North Sea has abundant sources of natural gas—to reduce the vulnerability of whatever dependence on the Soviet, Siberian natural gas, the Western European countries may wish to undertake.

I am not against Western Europe taking natural gas from the Soviet Union. I do think it is prudent and essential for strategic and geopolitical reasons for the Western allies to effect a common, agreed-upon strategy dealing with the problems that would attend that.

And I don't see that emerging quite as clearly as I would like to see it.

I think arguments over transfer of technology and embargoing licensees of American companies from selling component parts to the pipeline and so on, are of secondary importance. They are not the main game. The main game is to do in the natural gas area, which is going to be a fuel of growing importance for Western Europe, what we have tried to do with respect to oil. And while that exercise is underway, I'd like to see it go a lot faster than it is going.

Representative RICHMOND. Thank you.

Representative REUSS. Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

The chairman said you characterized the summit conference as a dud.

Representative REUSS. I did, but the witness did not.

Representative HAMILTON. I said you so described his characterization. And I had your testimony, whose opening sentences I missed, described to me as saying that the summit had already failed.

WHY CAN'T VERSAILLES ACHIEVE REAL RESULTS?

I guess my question is, why is that the case? What factors have come together here which cause you to be less than optimistic, if not downright pessimistic, that anything could be achieved?

Mr. RASHISH. Well, if I may correct that——

Representative HAMILTON. Sure.

Mr. RASHISH [continuing]. I didn't say the summit had already failed. I started out by saying how important summitry was, how relevant it was to the needs of the world, and how much potential summits have.

I said that this is a particularly dicey time for the world economy.

Representative HAMILTON. That seems to me to be a reason for something to come out of it, rather than for something not to come out of it.

Mr. RASHISH. I said it's a rather awkward picture, but I said I thought Versailles would suboptimize; that while it was good and important and that benefits would flow, the benefits would be less than what, optimally, they might be; and that Versailles might be an opportunity that would be at least partially missed.

Representative HAMILTON. Why?

Mr. RASHISH. Because I don't think the leaders of the seven countries are going to address the issues at Versailles that offer promise of some solution while maintaining the coherence of the alliance.

Representative HAMILTON. Is that the reason, if we address those issues, that the coherence of the alliance will be jeopardized?

Mr. RASHISH. I think if we don't address the issues——

Representative HAMILTON. Well, why don't we? I don't understand why we don't. You've got all of these big issues. I think the next witness, Mr. Cooper, is going to say that the world economy is in worse shape than it's ever been for 50 years. You have trade and exchange rates and East-West trade and North-South issues, and here we go to this summit and we are going to come out with a lot of platitudes.

Now, why is that happening?

Mr. RASHISH. It has to do with political imagination, political will, and political leadership.

Representative HAMILTON. So it's a lack of political leadership in the West that you put your finger on?

Mr. RASHISH. Yes.

POLITICAL WILL AND IMAGINATION MORE IMPORTANT THAN INSTITUTIONAL SETTING FOR COORDINATING POLICIES

Representative HAMILTON. Do you see any mechanisms or would you suggest any mechanisms through which the West can better deal with its economic problems? The summit conference, you have indicated, is a valuable exercise, worthwhile, and I'm sure all of us agree with that. But are there other, better means of coordinating macroeconomic policies among the industrial powers? More intensive consultation? What is the approach to this?

Mr. RASHISH. I tend to be a skeptic about institutional solutions to substantive problems. I don't believe in the deus ex machina approach. I think if you have political will, political imagination and so on, even primitive institutional arrangements can produce the results

that you want. On the other hand, if you don't have these essential ingredients, no elaborate and sophisticated set of institutional arrangements is going to produce them for you.

I think we have a full array, a complete panoply of institutional means for consultation and coordination, and whatever other words you want to throw in. We have all the international organizations—we've got the OECD, the GATT, the various subsidiary bodies of the OECD and the IMF: You're got the summit, and you've got whatever ad hoc groups you wish to put together for whatever purpose.

So the instruments exist, and if new ones are needed they could be easily created.

JAPANESE DOMESTIC POLITICS HAMPERS COMPLIANCE WITH SUMMITEERS

Representative HAMILTON. You suggested—if I may direct your attention to a specific country—that Japan should resist pressures to tighten its fiscal policy. The statements I have seen suggest that the Prime Minister there is anxious to get more budget deficits and is not moving in the direction that you are suggesting.

Do you think it's possible, given the realities of Japanese domestic politics, that they are going to move in the direction you are suggesting?

Mr. RASHISH. I think that the realities of internal domestic Japanese politics and the institutional structure of the Japanese Government makes it very difficult for the Japanese Government to do a lot of things that might seem to us to be sensible, including trade liberalization. And that is why I think in the case of Japan, perhaps more than in the case of other countries, it requires the introduction of external constraints and influences and pressures to force Japan to pursue policies, just as we are being asked to pursue policies, to make a better contribution to the equilibrium of the economic system as a whole.

And Japan's position in that system has changed sufficiently over time so it ought to pursue policies that are sensitive to the requirements of the world economy. And that applies not just to the trade area but to the whole array of policies which influence Japan's behavior in that world economic scene.

Representative HAMILTON. Thank you, Mr. Chairman.

Representative REUSS. Thank you.

Mr. Cooper.

STATEMENT OF RICHARD N. COOPER, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASS., AND FORMER UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. COOPER. Mr. Chairman and members, I appreciate very much the opportunity to testify once again before the Joint Economic Committee.

Before I get into the contents, let me say a little bit about summits themselves. It seems to me that economic summits perform three quite different, but all useful, functions.

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First, they serve as an occasion to inform heads of government about the contemporary economic issues, and in particular to put those issues into global perspective by indicating how national economic developments are seen by other nations. This is in itself no inconsequential accomplishment, given the heavy schedule of heads of government and their general preoccupation with foreign affairs in the more traditional sense.

Second, they provide an occasion to review the linkages among different issues, whether they be organic linkages or political linkages, and possibly to reach agreements on courses of action that acknowledge these linkages.

Third, they permit heads of government to get to know one another on a personal basis and to discuss with one another what most preoccupies them from their lonely vantage points as political leaders in the great industrial democracies.

It follows from this rendition of possible rules that to be successful a summit need not involve a package agreement on courses of action; it can have formed a useful role, and be far from a failure even if no formal agreement is reached at all.

Nonetheless, at the present time the world economy is in a perilous state, and publics everywhere look to their governments for guidance and for solutions to difficult economic problems. For this reason, a Versailles summit that does not seem to offer any agreed path out of our present travail will be justifiably considered a great disappointment.

WORST ECONOMIC SITUATION SINCE 1930'S

The economic situation is worse today than in any peacetime period since the 1930's, nearly 50 years ago. World trade declined in physical terms last year for the first time since 1958. Unemployment in the 7 summit nations is now in excess of 21 million individuals, and that represents an underestimate because of withdrawals from the labor force, especially in the United States and Japan, in times of weak demand.

Inflation as measured by the Consumer Price Index has dropped in most major countries from the temporary heights of 1980, and the drop has been especially dramatic in the United States. But much of that drop was inevitable once oil prices and, in the United States, mortgage interest rates ceased rising, and some further drop of it is due to temporary factors such as low agricultural and raw materials prices and appreciation of the U.S. dollar against other currencies. This appreciation has tended to worsen inflation in other countries, a point to which I return below.

The underlying or core rate of inflation, which was never double-digit, has been stubbornly resistant to decline, falling by only a percentage point or so in the past year.

Oil prices measured in dollars have fallen from their peak, though we should not forget they remain much above where they were only 3 years ago, which by itself is good news for oil-importing countries, although bad news for those oil-exporting countries—Nigeria, Mexico, Egypt—that have become highly dependent on growth in their oil export earnings.

The value of the drop of oil prices is reduced to others as well by, one, the depreciation of their currencies against the U.S. dollar, which means that local currency prices of oil have risen in some instances even while the dollar price has fallen and, two, by the even sharper fall in the prices of other primary products—for the same reasons, weak world demand—such that the terms of trade for primary products against manufactured goods is now the worst it has been since before World War II. And high interest rates, which normally fall sharply in recession, mean that debt servicing payments are up just when the ability of many countries to service their external debts has deteriorated sharply.

RESPONSE OF THE WEST TO IRANIAN REVOLUTION CONTRIBUTED TO CURRENT RECESSION

In short, the world is in a major recession; some would say a depression. How did it come about? The major cause was the Iranian revolution. One might call it Khomeni's revenge on a materialistic world. Without it, the world economy would not be where it is today. But our—by "our" I mean the Western industrial democracies—response to that revolution must share the responsibility, in two respects: first, the oil-buying public panicked with the loss of Iranian oil and bid up spot oil prices, followed by OPEC-posted prices, even though we now know that there was no shortage of oil. The extra demand went into stock building.

Second, having mistakenly bid up the price of oil, we compounded the mistake by confusing a once-for-all increase in the price level with a sharp increase in inflation, and then took steps to combat the inflation thus perceived. This mistake was made by many industrial countries, not just the United States; and it was an understandable mistake, since any major increase in the price level can increase the rate of inflation, given the structure of today's economies, by getting built into the wage-price setting structure.

Thus, an event such as the Iranian revolution confronts economic authorities in modern industrial countries with an acute dilemma—accommodation of the higher price level may seem to condone or even foster a higher rate of inflation; yet, not to accommodate the higher price level triggers a recession and a secondary loss of output. The problem is complicated further in the United States by the heavy weight of mortgage interest rates on the Consumer Price Index, which gives some force to Patman's dictum that high interest rates increase inflation rather than decrease inflation.

HIGH U.S. SHORT-TERM INTEREST RATES BLAMED FOR RECESSION

The proximate cause of the world recession is the Federal Reserve Open Market Committee. On virtually any measure, it has maintained money so tight that a deep recession was almost inevitable, and recovery will be anemic. Although down from their peaks, interest rates, especially the short-term interest rates that are fully under the control of the Federal Reserve, are extraordinarily high for a recession. It is noteworthy to recall that in the 1958 recession, Treasury bill rates fell

below 1 percent. Given what has happened to prices, these high short-term rates cannot be explained—as long-term rates might be—by high inflationary expectations. They are due solely to a tight monetary policy.

This tight monetary policy is being maintained in order to combat inflation. The assumption of this strategy is that inflation can be broken before anything else serious is broken, or, alternatively, that breaking inflation is so important that it does not matter what else is broken.

LONGRUN COSTS OF WORLD RECESSION

Apart from the enormous loss of output—running in the United States alone at an annual rate of at least $250 billion, which makes even President Reagan's defense budget look small—there are several longrun costs from the current policy. I will not dwell on those that are primarily domestic in character and effect—low levels of investment in housing, plant, and equipment, which we'll feel for decades after this episode; high actual or threatened bankruptcy rates leading to greater concentration of economic activity, and strengthening further the already excessively strong voices of lawyers and accountants as against entrepreneurs in business decisions; the alienation of youth from our main social values that comes from the loss of self-esteem associated with inability to find jobs, and so on.

Rather, I want to focus on two longrun costs that are more clearly international in character, although all of these effects that I have just mentioned will have longrun international ramifications.

PROTECTIONISM ENCOURAGED

The first is the encouragement to protectionism. The second concerns the ability of developing countries to achieve their aspirations peaceably and in a democratic environment.

Under a regime of flexible exchange rates, tight monetary policy exerts its influence on the economy through a new channel, in addition to the traditional effects via inventory liquidation, cutbacks on interest-sensitive investment, especially housing, and discouragement of consumption via less credit availability and reduced value of household assets, especially stocks. It is via a strengthened currency. Tighter money pulls up the value of the currency, and results in an immediate reduction of inflation insofar as the prices of foreign products are determined primarily in foreign markets. But by the same token, it makes foreign goods more competitive relative to American goods, both in foreign markets and in the U.S. domestic market.

Thus, sectors of the economy are now being hurt directly by tight money, via the exchange rate, that have in the past been hurt by tight money only by the recession that followed. But firms and workers do not attribute their new-found difficulties to the Federal Reserve; they attribute them to unfair competition from abroad. At a recent count there were 14 bills before Congress calling for reciprocity in trade relations, and over 50 bills that contained some elements of protectionism.

WEAK U.S. TRADE POSITION WILL OUTLAST STRONG DOLLAR

The weak U.S. trade position at the moment is concealed now by the recession, which holds down imports. But with recovery there will be a visible deterioration in the current account balance, which will add fuel to pressures for protection. The dollar will weaken, and paradoxically, that, too, will strengthen pressures for protection in the short run, although it will relieve them after a period of time. It will also reveal, however, that some of our reduction in inflation rates has been merely transitory.

How do these issues look from abroad? The Japanese yen has been very weak, a counterpart of the strong dollar. As a result, Japanese exports have generally held up despite world recession and have buoyed up the Japanese economy. It is inappropriate for a country the size of Japan to engage in export-led growth when the world is in recession, but U.S. monetary policy has abetted Japan in this regard. Japan, with its high domestic savings rates and temporarily weak investment, has been running large budget deficits—proportionately much larger than those in the United States. But they are moving now toward fiscal austerity to reduce the deficits. This action will strengthen further the Japanese trade position, and it is completely inappropriate under current world economic conditions.

Europeans have been vociferous in complaining about tight money in the United States. It inhibits them from moving toward greater economic stimulus for, if they do so, their currencies will depreciate further and they will feel at once the impact on prices, such as oil. Thus, our tight money under flexible exchange rates worsens the short-run tradeoff between inflation and real expansion.

There is some merit to the European argument. But they, like the Japanese, should also experience the beneficial effect of weaker currencies on their foreign trade position. To some extent, at any rate, that offsets the contractionary influence of high U.S. interest rates. When European currencies appreciate against the dollar, unless it is also accomplished by a vigorous economic recovery in Europe, the protectionism that is now strong there is likely to become ferocious.

So the liberal trading system that the United States and other countries have worked so hard to build over the past 35 years may break down under the pressures of this world recession, and if it does so it will take years to repair the damage. The breakdown has already started among less-developed countries, several of which have deliberalized their import regimes during the past 2 years.

Let me turn to the second question, and that is the problem of developing countries.

DEBT SERVICE BURDEN RISING FOR DEVELOPING COUNTRIES

As a group, they have accumulated an enormous volume of external debt since 1973. It now reaches over $350 billion on one measure. Because creditors have seen the real value of past debt service eroded by inflation, much of the new debt has carried floating interest rates,

which are now very high. At the same time, both the volume and the prices of primary and other products exported by these countries have declined, so the burden of serving the debt has grown on both counts. Arrearages have increased substantially during the last year, and there will have to be many debt reschedulings. We face, I think, many more rescheduling ahead of us.

Unlike during the 1974–75 world recession, when many developing countries tried to stay on their previous growth paths by borrowing abroad, and in so doing they cushioned the world recession, many today will retrench sharply and thereby contribute to the fall in world demand. We have already seen it in countries such as Brazil and Korea.

There will also be great political turmoil in many less-developed countries, with increased repression and delays in progress toward democracy. It is perhaps implausible, but not completely farfetched, to argue that even the Falkland Island crisis is a by-product of world recession and weak demand for such Argentine exports as grain, meat, and sugar. With stronger export markets, the Argentine leaders might not have been pushed into their desperate gamble to divert public attention, in which they have been highly successful, from economic adversity at home.

This brief survey of the world economy and the long run costs of world recession brings me back to the Versailles summit. Like Myer Rashish, I have a constructive package which might come out of it. In its broad features, it is not very different from the package that he suggested.

First, the foreign participants would impress upon the American participants the global consequences of our current economic policy, and the President would agree to trim expenditures and raise taxes in future years. There is no compelling need to reduce the budget deficit in 1982 or even, as things are now going, in fiscal 1983. What is necessary is a credible program for lower deficits in 1984 and beyond.

This action would provide the occasion for the Federal Reserve to ease up on monetary policy this year, when it is needed, without giving up its objective of reducing inflation. With current levels of unemployment and low capacity utilization rates, expansionist actions now would not be inflationary, except insofar as they lead to some depreciation of the dollar, which we must absorb sooner or later in any case.

Second, the Japanese and the Germans would agree to postpone their efforts to reduce their budget deficits.

Third, all participants would pledge to block protectionist actions. This is to some extent boilerplate for summits but it is nonetheless important, I think, for the leaders, all of whom recognize the disadvantage of protectionist actions to reinforce one another in their determination to block them.

The pledge must pointedly include the common agricultural policy of the European Community, including their practice of dumping surplus production of sugar and grains on the world market at a time of depressed world agricultural prices.

In my view, stimulating the world economy and limiting protectionism together would be far the most important things for the summiteers to do for the developing countries. In addition, I believe the United States should agree to honor its past pledges to finance the multilateral development banks, and to support them in the future.

Finally, the U.S. administration wants a stiffer posture toward trade with the Soviet Union. There are, I think, deep philosophical differences between the United States and the Europeans on this question. But it does seem to me, in the context of prospective world economic expansion, the Europeans and Japanese should agree and could agree to limit their official export credits and guarantees to the Soviet Union, but would not cut off private credits to the Soviet Union, and to raise the interest rates they charge to market levels. It is absurd for European taxpayers to subsidize the Soviet Union for the purpose of stimulating demand in their economies.

I think a package such as this would leave all the participants better off, and many others as well.

Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Cooper.

Mr. Norris.

STATEMENT OF JOHN F. NORRIS, VICE PRESIDENT AND MANAGING DIRECTOR FOR INTERNATIONAL ECONOMICS, CHASE ECONOMETRICS, BALA-CYNWYD, PA.

Mr. NORRIS. Thank you very much, Mr. Chairman.

It is indeed a pleasure to be here today, particularly with the distinguished colleagues to my right. It is difficult to add much new insights over and above what they have done, but I will attempt to do this.

The importance of the subject matter cannot be overstated. In my travels around Western Europe recently, I have never sensed as much tension that exists today, that is, a reflection of the tension between the United States and Western Europe, and the United States and Western Europe against Japan, and against the United States and Canada as well.

What I have also sensed is that most foreign governments believe that the shaping of U.S. policy over the past few years has taken place without due consideration being given to the international consequences of U.S. actions, and yet the need for international cooperation in global planning has increased rather than diminished as world economies have become more interdependent than ever before.

What I'd like to mention before going to the presentation is that the analyses and conclusions included in the paper prepared for the record are the sole opinion and responsibility of Chase Econometrics, and that they do not necessarily represent views of its parent company, Chase Manhattan Bank.

My prepared statement, submitted for the record, is rather lengthy. What I'd like to do is discuss only the highlights of it, and in the process of doing that, refer to some of the graphs and tables.

We have already discussed some of the aspects of the U.S. monetary and fiscal policy. Both were very contractionary in 1981. Much has been said about money supply declining in both years in real terms; real interest rates are exceptionally high by historic standards.

What there is less awareness of is that the fiscal policy in 1981 was actually a contractionary one measured from full-employment budget basis which was actually in surplus last year.

These policies, as we have concluded, are responsible for the 1982 recession here in the United States, as well as the slowdown in U.S. inflation.

And one final policy issue that I think has been given too little attention is that because of the high interest rates, we have seen an explosive rise in the dollar which, if you look at figure 4 of my prepared statement, the dollar in trade-weight terms is higher than it was in the 1970–71 period, prior to the Nixon administration's new economic program. And I believe we are all aware of the tremendous chaos in currency markets that followed the unsticking of exchange rates.

STRONG DOLLAR DAMAGING TO CURRENT ACCOUNT

But what this high dollar has done—and it is very unusual for this stage of the business cycle—is that it has retarded our exports as well as increased our imports to the extent that the change in the net exports since the peak of the current business cycle has been negative as opposed to positive in previous recessions. In fact, the decline in the export balance accounts for about 40 percent of the decline in the GNP since the peak of current business cycle. That is shown on table 1 of my prepared statement.

These economic developments, especially the decline in U.S. economic activity, the high level of U.S. interest rates, and the strength of the U.S. dollar have important consequences for economic activity in the rest of the world.

What I'd like to do is discuss briefly the consequences for Western Europe, for Japan, for Canada, and then a very brief discussion of the less-developed countries, and then follow that with a brief summary.

For Western Europe, the state of the economy, as Dick Cooper pointed out, is rather grim. The economy peaked in the first quarter of 1980, and the recession, which has continued since then, many say was initially caused by the oil shock and the initial policy reaction by the European governments.

I should point out that the peak-to-trough decline in the European economy has been as great as it was during the 1974–75 recession.

What did happen, however, is that the European economy more or less bottomed out in the middle of 1981 on the strength of an export-led recovery. However, the recovery has been exceptionally weak, and there are no signs of a typical European rebound.

What are the consequences of U.S. actions on Western Europe?

First, through the income effect of U.S. recession, the diminished import growth that we are currently experiencing will lead to lower exports from Western Europe to the United States during 1982. That is in contrast to the 1981 experience when Europe had fairly strong export growth to the United States.

The second set of effects I believe are more important, that is, the effects of the high dollar, high U.S. interest rates.

What has happened in Western Europe over the past year to year and a half is that the rise in the dollar has sent European currencies down against the dollar, which has led to significant increases in import prices and has kept European inflation up at a higher level than it would have been in the absence of the rise in the dollar.

Those phenomena are shown in tables 2 and 3 of my prepared statement.

EUROPEAN INTEREST RATES ABNORMALLY HIGH DUE TO U.S. TIGHT MONETARY POLICY

The second effect is that because of the threat of higher inflation stemming from the higher import prices, European central banks have tight monetary policies to prevent further rise or fall in their currencies against the dollar, or have maintained interest rates at higher-than-desired levels.

But much of the criticism and vehemence that I see among European government leaders stems from this problem, that is, the constraint that they feel they have had on the operation of monetary policy stemming from the high interest rates here in the United States.

I believe it is also important to point out, however, that European central banks have not moved in lockstep with U.S. Fed policy. If you look at figures 9, 10, and 11 of my prepared statement, you will see that virtually no country has followed U.S. interest rates in lockstep. And in a number of cases, such as France and Italy, interest rates would be about the same as they are now due to domestic considerations: in France, the expansionary budget and its high inflation, and in Italy, an inflation rate that is somewhere between 15 and 18 percent and a budget deficit that is even greater than ours as a proportion of GNP.

But on balance I would have to say that European interest rates are definitely much higher than they would normally be during this stage of the business cycle. And this has had an important negative effect on business spending as well as spending on consumer durable goods.

IMPROVEMENT IN EUROPEAN INTERNATIONAL PRICE COMPETITIVENESS

Now, the third effect has actually had a positive effect on the European economy, and that is the decline in the European currencies has resulted in a tremendous improvement in European international price competitiveness; and I refer to figures 12, 13, and 14 of my prepared statement.

What they show is that for a number of the countries the price competitiveness vis-a-vis the United States and to a lesser extent against Japan is better than it has been since the early 1970's. Germany has improved its competitiveness by far the greatest amount against the United States, while the United Kingdom, which is shown on figure 13 of my prepared statement, has improved its competitiveness the least.

Now, Dick Cooper has pointed out that in 1981 world trade actually declined in volume terms. The importance of this improvement of price competitiveness for Europe cannot be understated since it did enable Europeans to increase their exports in volume terms during 1981. Germany had about a 7-percent increase in its volume of exports, France around 4 percent, Italy around 5 percent.

So I think it is important to point out that there have been some positive effects of this high-interest-rate policy in the United States, and it lies mainly in the improvement in European price competitiveness and the rebound in exports that did occur in 1981.

GROWTH OF WORLD TRADE DEPRESSED BY HIGH U.S. INTEREST RATES

However, the problem with this argument is that the persistence of high interest rates in the United States, which has caused the second downturn in this economy in 2 years, has caused a spreading of recession conditions throughout the rest of the world, and this has choked off growth of world trade to the extent that even with the price competitiveness that the Europeans gained or now have, they are able to ship their exports or grow their exports, as they were doing in 1981.

A very good example of this is Germany, which I said has experienced the greatest degree of improvement in its international price competitiveness. When the German mark began to decline against the dollar in early 1980, it was followed in a matter of 4 to 6 months by a tremendous rise in German foreign orders. And that is shown on figure 15 of my prepared statement.

And German export orders rose tremendously between the middle of the spring of 1980 through the middle of the spring of 1981. And that was followed by a pickup in export deliveries which I cited just a moment ago.

However, even the strength of German competitiveness has not enabled German foreign orders to continue to rise past the middle of 1981. And this, as I mentioned, is the result of the spreading of the worldwide recession.

In addition, German domestic demand—if you look at figure 15 of my prepared statement, there's a line there that gives you domestic orders—domestic orders have continued to decline for the past 1½ or 2 years, partly as a result of the exceptionally high interest rates, partly as a result of the higher inflation that Germany has experienced because of the higher import prices.

So in the case of Germany, I think it is very important that if we would have a decline in U.S. interest rates, we would have a concomitant decline in German interest rates.

In the case of Japan, I'd like to mention briefly the state of the economy. There has been no recession to speak of. The economy during 1980 and 1981 had 2 years of solid growth. We, as Americans, would criticize the Japanese for how they have achieved that growth, but I look at it more from the perspective of better management or good management of their economy, at least from the perspective of a Japanese citizen.

I have used table 24 of my prepared statement in many presentations to elaborate or to illustrate how the Japanese have managed their economy. And it is really the epitome of success.

If you look at that table it shows first differences in the composition of aggregate demand, first differences measured in real 1975 dollars.

What you see is that between 1978 and 1981 the economy has a fairly constant growth on an overall basis. However, the composition of growth changed significantly from domestic-led demand in 1978–79 to almost entirely foreign-led demand in 1980–81.

Let me set that aside for a moment.

As Dick Cooper has pointed out, U.S. policies have contributed to the performance of the Japanese economy as well as contributed to the

operation of monetary and fiscal policy. This has happened in two ways.

First, the high interest rates have prevented the banks who can from lowering interest rates as they would normally do with an inflation rate of 3 to 3.5 percent.

Figure 16 of my prepared statement gives you the path of Japanese interest rates relative to the path of U.S. interest rates. As you can see, they attempted to lower interest rates. Interest rates have been declining since the middle of 1980. In my opinion they would be much lower in the absence of high U.S. interest rates.

And this high level of Japanese interest rates has prevented, in my opinion, a recovery, or is partially responsible for the absence of a recovery, of the Japanese yen. You can't ignore, however, the fact that fiscal policy in Japan has been restrictive. And I think there has been some confusion as to whether a high budget deficit in Japan is expansionary. In my opinion it is not because the government's current direction of policy is to reduce that deficit, to reduce it by reining in government spending, and possibly increasing taxes.

So fiscal policy has also been restrictive, and it has led to the further retardation of domestic demand.

JAPANESE GOODS AS COMPETITIVE AS IN EARLY 1970'S

The second consequence of U.S. policy is related to Japanese price competitiveness, which is shown on figure 17 of my prepared statement and you can see that Japanese goods, in the lower graph of that figure, are more competitive than they have been since the early 1970's against U.S. goods, and equally competitive against European goods.

LOWER JAPANESE WAGES, GREATER PRODUCTIVITY GAINS

Now, I could probably spend a day trying to explain that phenomenon. But I will point out two important features of domestic policies in Japan. One is that the level of wages in Japan are approximately half of what they are here. Second, the level of productivity gains or the rate of productivity gains in Japan averages about 8 percent in the 1978–82 period with gains on the order of 15 to 20 percent in some of the dynamic industries such as transportation and electrical machinery.

So on those two counts, the Japanese can be very competitive. And it would also dictate that the yen would be one of the strongest currencies in the world.

YEN UNDERVALUED

However, since we have had a very high interest rate posture here in the United States, the yen has been under periodic downward pressure, and as a result it is a tremendously undervalued currency, and our U.S. policies have contributed to the improvement in the price competitiveness that is shown on this graph in figure 17.

And that price competitiveness has enabled Japan to achieve its export boom, the export boom of 1980 and 1981, which has raised international trade tensions, particularly here in the United States and Western Europe.

Now, you could say that the Government should stimulate domestic demand, or perhaps pause in its goal of constraining the large budget deficits.

In my opinion, it has already done this. It has made some compromise on fiscal policy. It has not reduced the deficit as it originally planned. However, the more critical issue is the interest rate issue. One way to get the yen higher would be to increase rates. This is not a desirable course of action because it would further weaken domestic demand. On the other hand, if Japan unilaterally lowered interest rates, it would probably weaken the yen further and improve the price competitiveness and worsen international trade conditions.

CANADIAN ECONOMY CLOSELY LINKED TO AMERICAN ECONOMY

There is too little attention, I believe, being placed on the interrelationships of the United States and Canadian economies.

When the United States prospers, so does Canada; and when the United States slumps, so does Canada. So when the United States, at least on a yearly basis, had a decent yearly growth in 1981, so did Canada. The United States was in the midst of a recession and so was Canada.

And in particular the Canadian economy, particularly its export sector, has been hit very hard by this slump in the U.S. autos and the slump in the housing sector, plus the worldwide slump in mining and minerals.

Much of this has to do with high interest rates, interest rates that in Canada have moved in lockstep with U.S. interest rates because of the close financial links and links in other parts of the economy. There is no one who would be happier than the Canadians to see lower U.S. interest rates and an improved U.S. economy.

In terms of the less-developed countries, I don't have much to say about this group of countries. It will be treated in the third session.

GREATER DEBT SERVICE FOR LDC'S DUE TO HIGH U.S. INTEREST RATE

Dick Cooper explained some of the effects of U.S. policies on the less-developed countries. They are, in my opinion, more indirect than direct. The most significant direct impact has been the significant increase in debt service requirements that have stemmed from higher U.S. interest rates.

However, there has also been an erosion of the current account balance resulting from a decline in export volume and the decline in commodity prices, both associated with world recession and the United States as part of both those phenomena.

The third factor, which has not been addressed so far, is that because of the debt servicing difficulties, because of the difficulties in current account balances, a number of the less-developed countries have reverted to more restrictive policies, partly in an attempt to correct the balance-of-payments deficits and partly in response to increased borrowing difficulties.

The net effect has been that there has been a very sizable acceleration in growth of nonoil less-developed countries.

U.S. INTEREST RATE LEVELS DESTABILIZING FOR FOREIGN ECONOMIES

In summary, I must conclude that U.S. policies have had a destabilizing effect on the foreign economies. The most pressing problem is the exceptionally high interest rates that have deepened the European and Canadian recessions and have prevented a policy easing in Japan and contributed significantly to the worsening of economic conditions in the LCD's.

The silver linings are few. As I pointed out before, Europe has benefited from an improvement in international price competitiveness, world inflation has receded, and there exists a greater awareness of the need for lowering inflation and maintaining conservative policies, which should have longrun monetary effects.

The key questions are whether the gains from these positive aspects justify the rise in unemployment that has taken place, and whether the world economy can return to a stable, low-inflationary growth environment.

We strongly support a change in direction of U.S. policies, and I guess I am as reluctant as Europeans are to recommend exactly what should be done. I think that is one of the difficulties, why we won't get a lot of discussion in Versailles on this subject matter.

But we would welcome a change in direction of policies that would lead to a much lower level of U.S. interest rates. This would certainly improve the climate for business and consumer spending in the industrialized nations, particularly Japan, Canada, and Germany, and would ease the financial burden of the LDC's while providing the LDC's with improved export prospects.

EUROPEAN ECONOMICS BEAR STRUCTURAL PROBLEMS

However, I must be fair in my assessments by stating we do not believe lower U.S. interest rates are a panacea for the problems of Western Europe, and for that matter, most other industrialized nations and LDC's. For Western Europe there are many structural problems which exist which prevent a sustained recovery from taking place even if U.S. interest rates would fall by so many points. Some of them are the chronically high level of unemployment, which is more structurally related than cyclically related, because of the demographic situation. The government deficits in most European countries are much larger than they are here in the United States, and we don't see much chance that they will be reduced significantly in the years ahead because of the commitment to social welfare in the Western European countries.

Another structural difficulty in Europe is that there is tremendous divergence in the inflation performance among the European countries. Germany, the Netherlands, and Switzerland, the low-inflation countries, are likely to continue to be so for the rest of this decade, while Italy, France, and the United Kingdom are high-inflation countries, and at least for Italy and France we expect them to be high-inflation countries for the foreseeable future.

EUROPEAN INDUSTRIAL STRUCTURE POORLY SUITED FOR COMPETITION IN 1980'S

Finally, the European industrial structure is not well suited for the decade of the 1980's. Employment is still concentrated in the smokestack industries such as iron and steel, chemicals, and autos, and not enough emphasis has been placed on improving technology, introducing laborsaving devices, raising the capital-labor ratio, and putting Europe in a better position to compete with Japan and the newly industrialized countries.

POOR CANADIAN MANAGEMENT-LABOR RELATIONS

The same is true of Canada. It has its own set of problems that won't go away, even if the United States had lower interest rates. The management-labor relations are very poor in Canada. It is quite amazing to me that we would have such a close link between the United States and Canadian economies and during a period of wage acceleration here in the United States we are seeing very little, if none of that, in Canada.

There are also problems with the Federal and provincial governments, particularly with respect to taxation and energy policies which have caused a tremendous amount of uncertainty in the business community.

The problem of Japan will not go away, either. Japan, as I said, is very competitive on its wages. It is very competitive on productivity. The yen is not an international currency. And I do not see Japan retreating from the international trade fight.

Moreover, many of the LDC's are greatly overextended, and this will pose serious financial burdens upon them in the foreseeable future.

Moreover, the LDC's are likely to face hostile markets particularly in the industrialized nations.

This statement on industrial difficulties in Europe, Canada, and the problem of Japan and the LDC's should not be taken as against an easing of U.S. monetary policy or a change of direction of U.S. policy or the change in mix of policies. We certainly support that. And I think lower interest rates would have a beneficial impact on the foreign economies.

However, again I repeat, it is not a panacea for the problems of Western Europe and the rest of the world.

Thank you.

[The prepared statement of Mr. Norris follows:]

PREPARED STATEMENT OF JOHN F. NORRIS

THE INTERNATIONAL CONSEQUENCES OF U.S. ECONOMIC POLICY

by John F. Norris, Romualdo A. Roldan and David W. Rolley

Introduction and Summary

The world economy is currently in the midst of a recession that began with the oil price shock in 1979. The signs of recession are most evident in the OECD area where the ranks of the unemployed have resulted to 24-25 million, including 10.6 million in the EEC and 10.3 million in the United States. However, economic strains are not limited to the industrialized nations, as the lesser developed economies as a whole have suffered a serious decline in real growth, with a number of key LDCs showing an absolute decline. The causes of the worldwide economic malaise were originally thought to be solely related to the doubling of oil prices, but over the past year or more U.S. economic policy has come to the forefront as a primary reason—and many say the sole reason—for the worldwide recession.

In our view, U.S. monetary and fiscal policy were contractionary in 1981, which has been responsible for (a) the 1982 recession in the United States, (b) the level of U.S. interest rates, (c) the slowdown in U.S. inflation, and (d) the strength of the U.S. dollar.

These developments, especially the decline in real U.S. economic activity, the high level of U.S. interest rates and the strength of the U.S. dollar, have important consequences for economic activity in the rest of the world.

The consequences for the **industrialized nations** include:

- the acceleration of European import prices which raised European consumer price inflation and deepened the European recession.
- the rise in European interest rates, which also deepened the European recession.

- the improvement in European price competitiveness, which has helped to raise European exports, which partially offset the domestic slump.
- the inability of Japan to lower interest rates, which has prevented a recovery in domestic demand.
- the improvement in Japanese price competitiveness far beyond the gains already achieved by Japan's low wages and high productivity, which caused a tremendous export boom and a raising of international trade tensions.
- the 1982 Canadian recession.

The **lesser developed economies** have also been affected by U.S. economic policies, but the effects are more of an indirect nature than direct. The direct and indirect consequences of U.S. policies include:

- a significant increase in debt service requirements due to higher interest charges.
- an erosion of the current account balances resulting from a decline in export volume to the industrialized nations and the decline in commodity prices.
- a reversion to more restrictive policies partly in an attempt to correct balance of payments deficits and partly in response to increased borrowing difficulties.

In summary, U.S. policies have had a destabilizing effect on the foreign economies. The most pressing problem is the exceptionally high interest rates that have deepened the European and Canadian recessions, prevented a policy easing in Japan and contributed significantly to the worsening of economic conditions in the LDCs. The silver linings are few: Europe has benefited from an improvement in international price competitiveness, world inflation has receded and there exists a greater awareness of the need for lowering inflation and maintaining conservative policies. The key questions are whether the gains from these positive aspects justify the rise in unemployment that has taken place, and whether the world economy can return to a stable, low-inflationary growth environment.

We strongly support a change in direction of U.S. policies that would lead to a much lower level of U.S. interest rates. This would improve the climate for business and consumer spending in the industrialized nations, particularly Japan, Canada and Germany, and would ease the financial burden of the LDCs while providing LDCs with improved export prospects. However, we do not believe lower U.S. interest rates are a panacea for the problems of Western Europe, and for that matter most other industrialized nations and the LDCs. Significant structural problems exist in Western Europe and Canada, and the problem of Japan's competitiveness will persist for the foreseeable future, which will be a source of trade friction. Moreover, many LDCs are overextended and will face hostile markets in the industrialized nations even if a cyclical recovery does occur.

U.S. Economic Policy in 1981

The 1981-82 U.S. recession has been chiefly due to economic policy. Both monetary and fiscal policy were restrictive in 1981. The stance of U.S. monetary policy can be viewed from either a money growth or an interest rate perspective. In 1981, as in 1980, the growth of the money supply was slower than the inflation rate. Therefore, the real, or inflation-adjusted U.S. money supply declined for a second consecutive year (Figure 1). The level of inflation-adjusted interest rates meanwhile rose steeply, as can be seen in Figure 2. So from either perspective, 1981 was a period of extremely tight money. What is less widely appreciated is the circumstance that fiscal policy was contractionary in 1981 as well.

The standard measure of fiscal policy is the "high employment" deficit. The actual budget deficit naturally widens when economic growth is weak, since tax revenues are reduced and unemployment compensation increased. The high employment deficit adjusts for these effects, and therefore measures the discretionary change in the fiscal

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FIGURE 1
REAL U.S. MONEY GROWTH

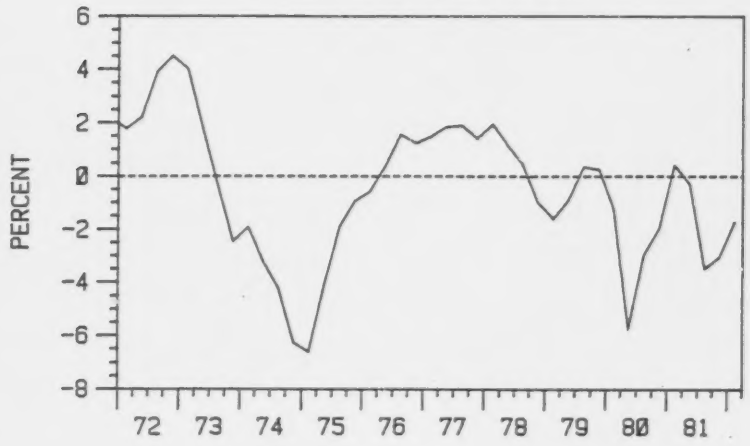
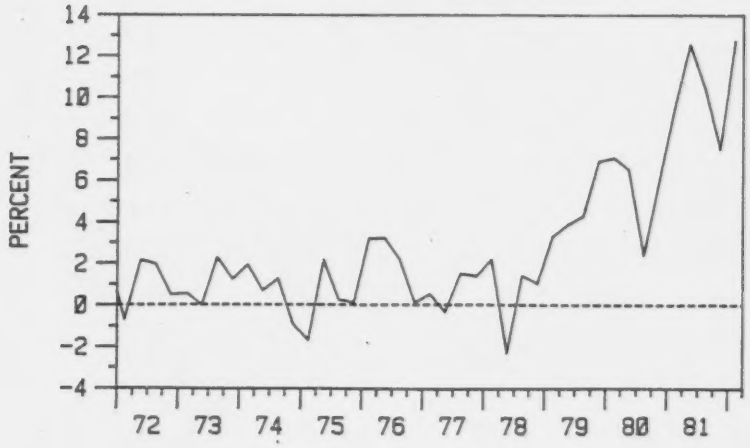


FIGURE 2
REAL U.S. INTEREST RATES



policy stance. As Figure 3 illustrates, the high employment budget was actually in surplus last year, so fiscal policy was contractionary, not expansionary, despite the large actual recorded deficit.

One final policy issue is noteworthy. The reduction in U.S. money growth together with the associated high U.S. real interest rates have produced a dramatic appreciation of the U.S. dollar (Figure 4), which has slowed the growth of U.S. exports and sped the growth of U.S. imports. Hence, unlike every other postwar U.S. recession, in which U.S. net exports generally rose, net U.S. exports have fallen, thus contributing significantly to the decline in GNP (Table 1).

TABLE 1

PEAK TO TROUGH MOVEMENTS
(Billions of 1972 Dollars)

	Change in GNP	Change in Net Exports
1969.3 - 1970.1	-11.0	3.0
1973.4 - 1975.1	-60.7	11.1
1980.1 - 1980.2	-38.9	1.6
1981.1 - 1982.1	-32.8	-13.0

Impact on the Industrialized Nations

Europe. European economic activity has followed a smoother path than the stop-go-stop experience in the United States. Real growth peaked in the first quarter of 1980, and declined continuously through mid-1981. Thereafter, a relatively strong export recovery, plus the stimulative policies followed in France, produced a small rise in real GNP in the second half of 1981. But the recovery has been very weak, and after a 4.9

FIGURE 3
U.S. HIGH EMPLOYMENT BUDGET
SURPLUS OR DEFICIT

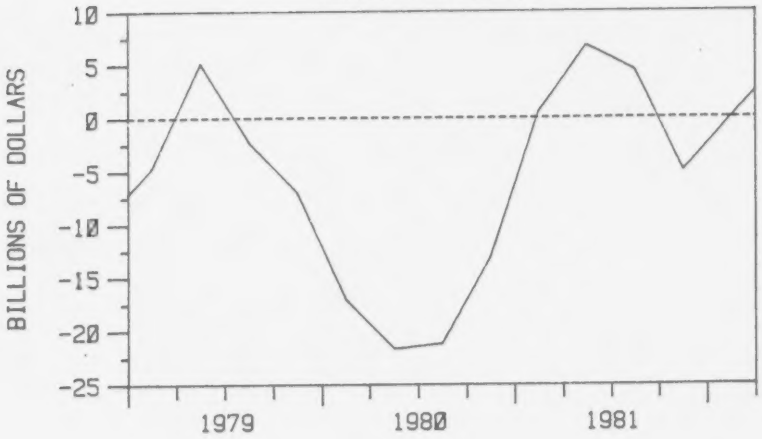
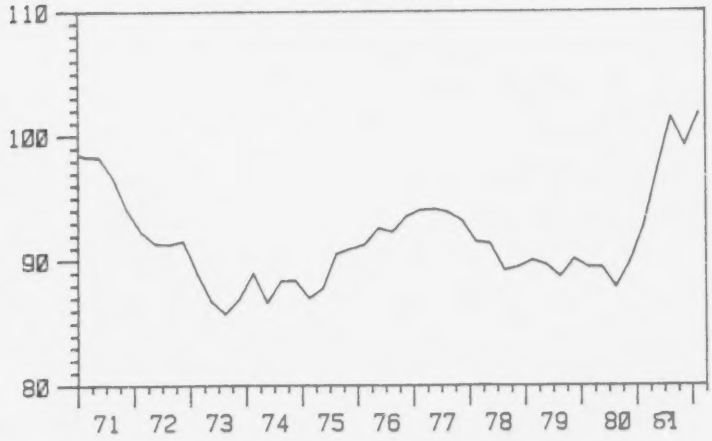
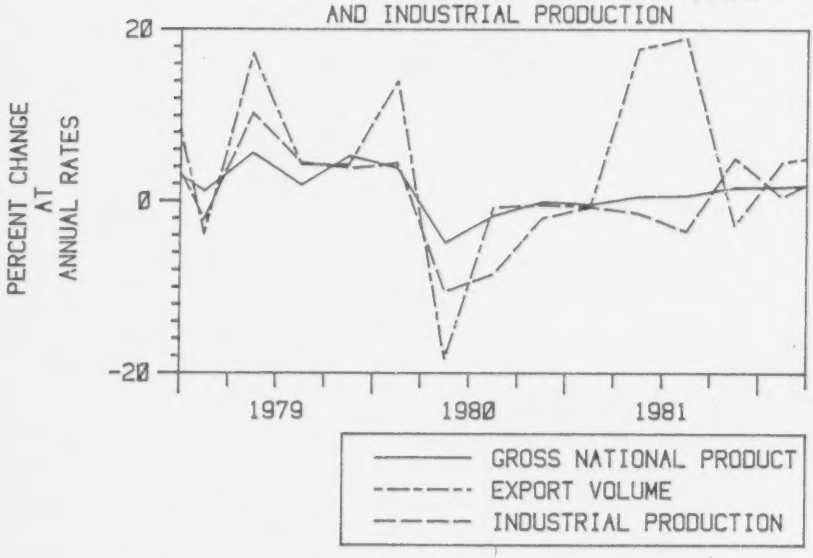


FIGURE 4
TRADE-WEIGHTED U.S. DOLLAR
(1970=100)



percent rise in 1981.4, industrial production has declined by 0.9 percent in 1982.1 (Figure 5).

FIGURE 5
EUROPEAN GROWTH:
GROSS NATIONAL PRODUCT, EXPORT VOLUME
AND INDUSTRIAL PRODUCTION

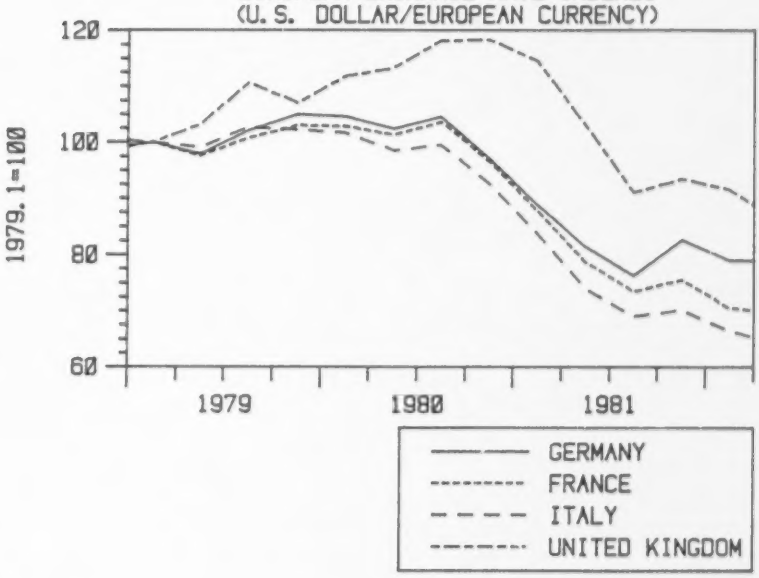


The economic impact of U.S. actions on Europe can be separated into two parts: (1) the consequences of reduced North American real growth, and (2) the consequences of high U.S. interest rates and a strong U.S. dollar. The former has reduced the prospects for European exports in 1982. The latter's consequences have been more complex.

Outside of Europe itself, North America is after OPEC, the second largest market for European exports, taking some 19 percent of exports net of intra-European trade in 1980. The value of European exports to the United States rose at a 17 percent rate during 1975-80, years in which U.S. nominal GNP growth averaged 11 percent. Hence, the slump in 1982 North American activity has significantly cut the prospects for export growth in one of the largest foreign markets for European products.

The obverse of U.S. dollar strength has been European currency weakness (Figure 6). As an example, the exchange rate for the Deutsche mark, for years the strongest major European currency, fell 24 percent against the dollar in 1981. The consequences of currency weakness have been threefold:

FIGURE 6
EUROPEAN EXCHANGE RATE INDEXES
(U. S. DOLLAR/EUROPEAN CURRENCY)



(1) The appreciation of the U.S. dollar has caused a significant rise in European import prices. As indicated in the Table 2, most European economies experienced a significant rise in imported inflation between the fourth quarter of 1980 and the third quarter of 1981, when the U.S. dollar strengthened considerably. The weakness in the U.S. dollar during the fourth quarter of 1981 helped to reverse part of the previous rise in import prices, but this was temporary, and the renewed strengthening in the first quarter of 1982 caused a further increase in European

import prices. The extent of the rise in import prices has been tempered by several offsetting factors.

TABLE 2

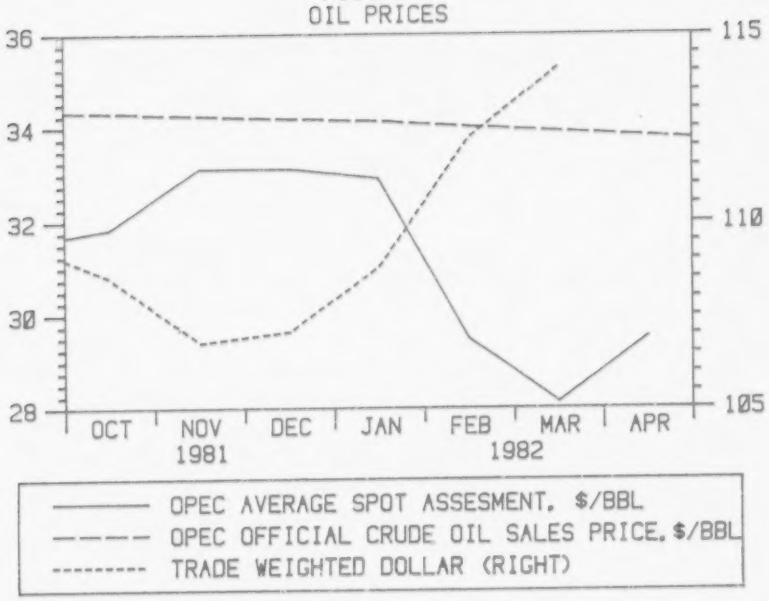
IMPORT PRICES - LOCAL CURRENCY
(Percent Change From Previous Quarter - Annual Rates)

	1980.3	1980.4	1981.1	1981.2	1981.3	1981.4	1982.1[e]
United Kingdom	-0.7	1.5	3.1	-1.2	67.0	1.9	16.7
West Germany	3.3	22.7	18.2	12.8	21.4	-5.3	-2.1
France	7.4	13.2	34.0	19.0	28.5	-4.7	17.5
Italy	4.4	26.9	63.5	42.0	34.1	-6.4	15.6
Belgium	0.1	13.2	33.3	11.0	18.0	-3.4	22.7
Netherlands	-15.0	16.2	4.0	-10.1	-5.2	-15.2	6.4
Japan	4.5	-4.1	-10.3	12.0	14.9	-10.1	-2.3
Canada	13.2	6.0	20.0	8.8	9.6	-8.8	-6.8
United States	-1.0	9.6	9.3	-2.5	-14.3	-1.7	-3.3
Trade-Weighted Dollar (level)	87.8	89.9	92.7	97.2	101.4	99.1	101.7

[e]estimated

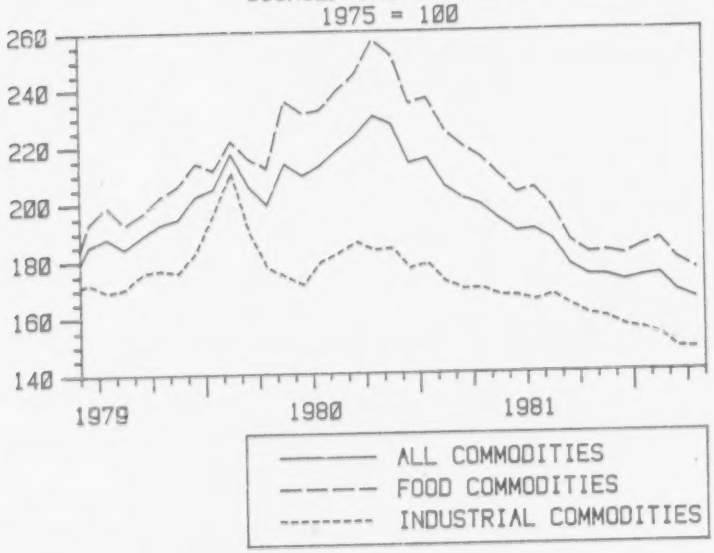
First, dollar-denominated crude oil prices fell throughout most of 1981 and the early months of 1982. As shown in Figure 7, spot oil prices declined from $38.71 per barrel in December 1980 to $33.13 per barrel in December 1981, and $28.13 per barrel in March 1982. This phenomenon is attributed to a complex set of factors, including the OECD recession, particularly in smokestock industries, increased conservation and inventory liquidation, the latter of which has been mainly caused by high interest rates.

FIGURE 7
OIL PRICES



Second, high interest rates and the strong dollar contributed significantly to the decline in non-petroleum commodity prices. This is exhibited in Figure 8, which shows that the overall Economist index of industrial commodities has been on a downward trend since early 1980. Similar to the impact of high interest rates on oil prices, industrial raw material prices can be attributed partly to the inventory selloffs stemming from high carrying costs. High U.S. interest rates and the strong dollar have also reduced inflationary expectations, which in turn has diminished the attractiveness of holding raw materials as an inflation hedge. Food prices have declined since the middle of 1980, due to the better-than-anticipated world food demand/supply situation, although high interest rates also had an impact.

FIGURE 8
DOLLAR COMMODITY PRICE INDICES
SOURCE: THE ECONOMIST
1975 = 100



Thus in our opinion, while the higher dollar raised the local currency price of imported goods for the European countries, the increase was restrained by the decline in oil prices and the fall in non-petroleum industrial raw material prices. Moreover, the impact of the rise in import prices on wholesale and retail price inflation in Western Europe has been held down as a result of a moderation in wage settlements and a reduction in profit margins, both of which can be attributed to the severity of the European recession. Nonetheless, European inflation has not fallen by as much as U.S. inflation over the past year and one half, and this is partly a result of the rise in import prices (Table 3). The relatively higher inflation has, in turn, reduced domestic purchasing power and contributed to a tighter fiscal and monetary stance in the affected countries, and hence weakened real growth.

TABLE 3

CONSUMER PRICES - LOCAL CURRENCY
(Percent Change From Previous Quarter - Annual Rate)

	1980.3	1980.4	1981.1	1981.2	1981.3	1981.4	1982.1[e]
United Kingdom	9.3	11.7	10.5	15.8	7.5	13.3	6.6
West Germany	4.7	5.0	6.4	6.1	7.0	6.7	4.5
France	12.3	12.5	13.5	13.0	15.6	14.6	12.4
Italy	21.6	21.5	19.8	18.6	16.3	18.3	12.9
Belgium	7.4	8.9	7.6	5.4	10.6	8.1	6.4
Netherlands	6.6	5.4	7.7	6.3	6.9	8.0	5.5
Japan	6.8	5.4	5.3	2.4	3.4	5.1	2.3
Canada	11.7	12.7	14.2	12.8	11.6	10.9	12.9
United States	7.6	12.8	11.0	7.8	11.8	7.8	3.9
Europe	11.1	12.0	12.6	13.2	11.0	13.0	9.3

[e]estimated

(2) The threat of accelerating inflation stemming from the rise in import prices has prompted European central banks to maintain higher interest rates than normal during recessions. Much of the reason for the higher-than-desired level of European interest rates has been attributed to high U.S. rates, implying that governments have lost control of management of their economies. This is not entirely true since, reacting to increases in U.S. interest rates, governments have at least three choices. **First,** they can also raise interest rates to defend their currencies and suffer the consequences of weaker domestic demand. **Second,** they can follow an independent policy by maintaining or lowering interest rates and incurring higher imported inflation as a result of the lower exchange rate. If domestic inflation did not worsen significantly, this course of action would eventually lead to an improvement in the trade balance and less pressure on the currency. **Third,** exchange and/or capital controls could be introduced as a means to insulate an economy from high U.S. interest rates.

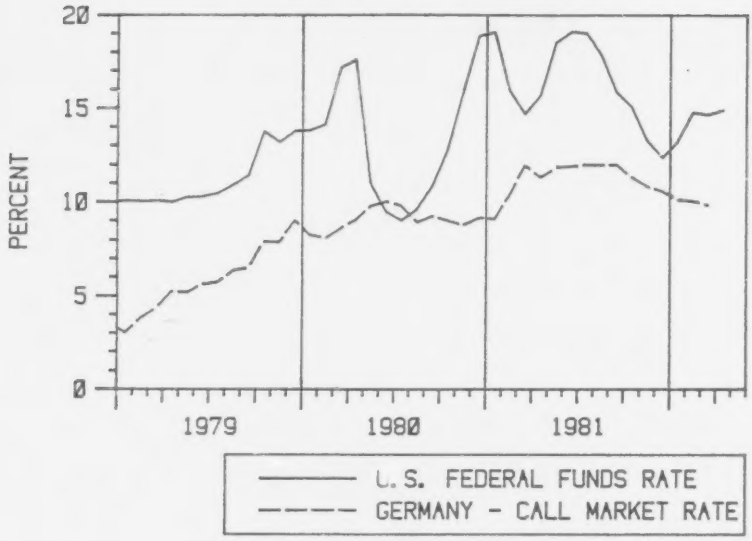
The following set of graphs presents evidence that foreign central banks have not followed U.S. monetary policy in lock-step over the past two years. For example, the Bank of England lowered U.K. interest rates against the upward trend in U.S. interest rates in the period between mid-1980 and mid-1981, and raised interest rates when U.S. interest rates were declining in the latter part of 1981. The Deutsche Bundesbank raised interest rates when U.S. interest rates were falling in the spring of 1980 and in early 1981, but this central bank hiked domestic rates only a trifle in the spring of 1981 when U.S. interest rates rebounded. Monetary authorities in France and Italy have criticized Federal Reserve policies, but interest rates in these two countries have more to do with domestic conditions—the Socialist victory and the expansionary fiscal policies in France and the persistence of very high inflation in both countries—than with high U.S. interest rates.

On balance, we feel that the overall level of interest rates in Western Europe would have been lower than experienced in the absence of high U.S. interest rates. Therefore, European interest rates have been higher than they would otherwise have been, with negative consequences for the interest-sensitive construction and investment goods industries.

Germany is the most significant example since inflation has receded to a reasonably low level and yet real interest rates are still unacceptably high. Given the German government's priority of reducing inflation, and its aversion to using exchange or capital controls, U.S. monetary policy can be given as a major factor for the high level of German interest rates and state of German domestic demand. However, the recent fall in commodity prices and oil prices opened a window for German monetary authorities to lower German interest rates by a notch in spite of continuing high U.S. interest rates.

FIGURE 9

GERMANY - UNITED STATES
INTEREST RATE COMPARISON



FRANCE - UNITED STATES
INTEREST RATE COMPARISON

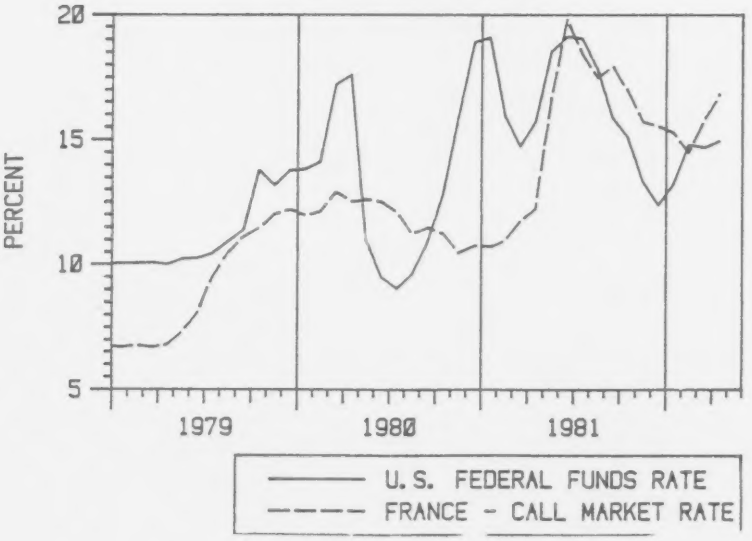
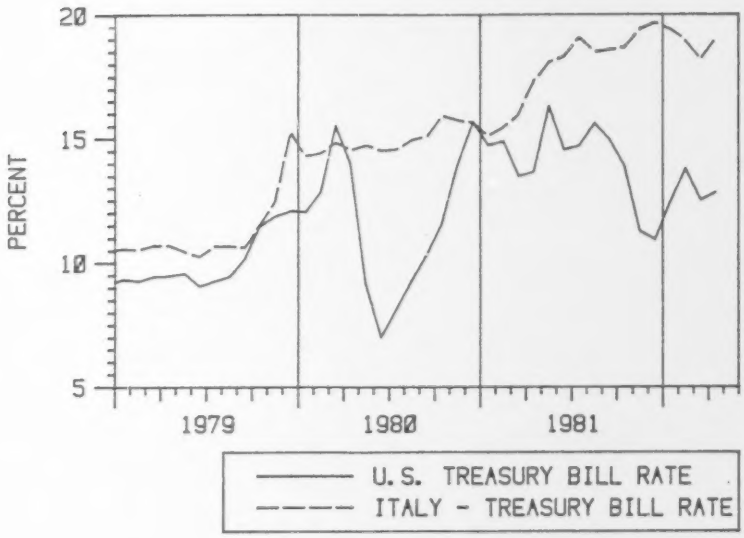


FIGURE 10
ITALY - UNITED STATES
INTEREST RATE COMPARISON



UNITED KINGDOM - UNITED STATES
INTEREST RATE COMPARISON

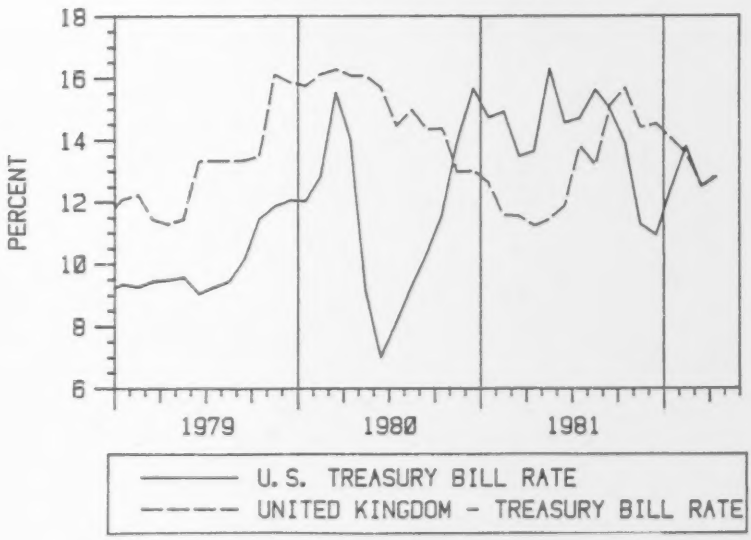
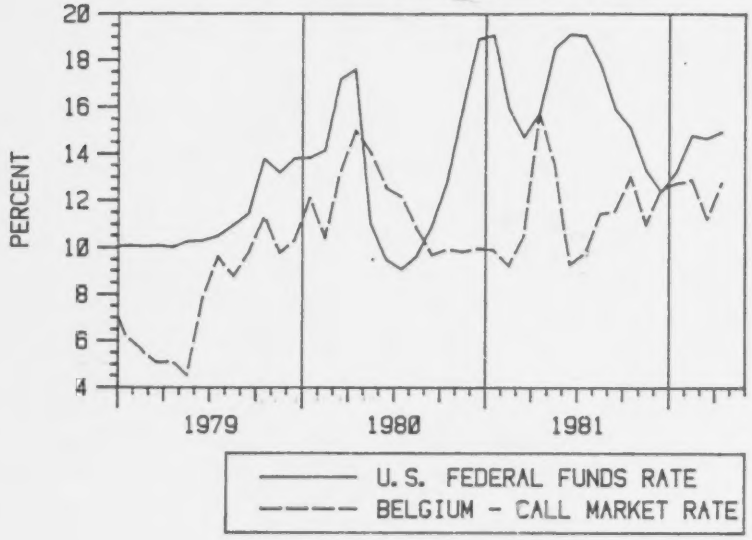
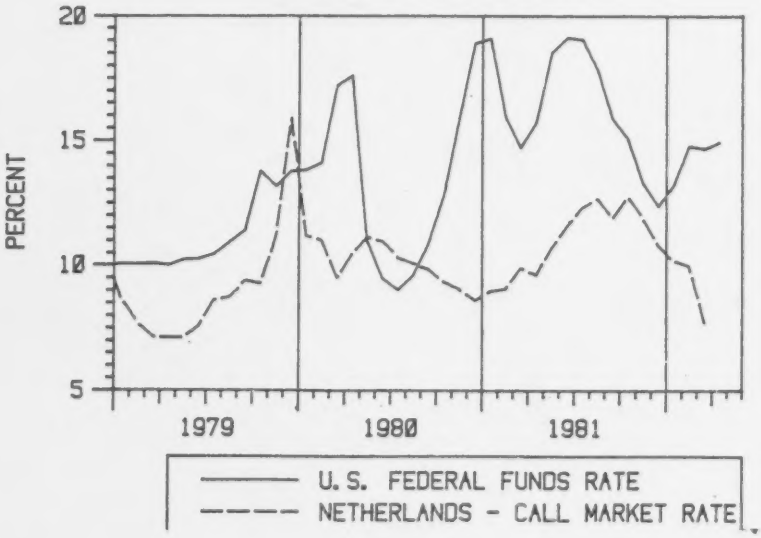


FIGURE 11

BELGIUM - UNITED STATES
INTEREST RATE COMPARISON



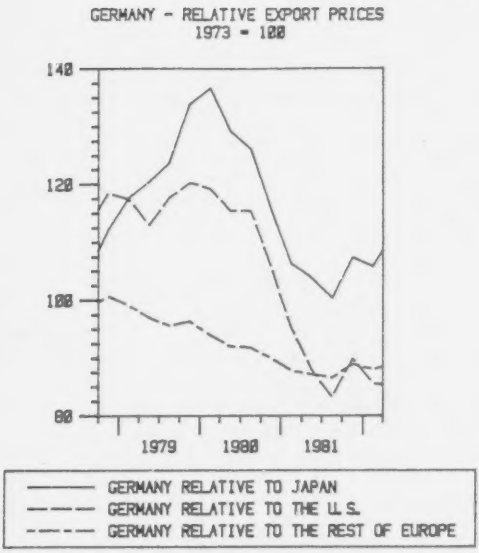
NETHERLANDS - UNITED STATES
INTEREST RATE COMPARISON



(3) The final consequence of the strong dollar has helped, rather than harmed, European growth. The decline in the European currencies has led to a major improvement in European price competitiveness. Figures 12 through 14 illustrate the transformation in relative export prices that has accompanied the currency swing. During the year and one half to two years, most European producers have regained the level of price competitiveness that they last enjoyed since the early 1970s. However, the degree of improvement in price competitiveness has varied considerably across countries. Germany has experienced by far the greatest improvement in price competitiveness, a result of its relatively low inflation and the decline in the Deutschemark against the U.S. dollar and Japanese yen. The improvement in price competitiveness has not been as great for Italy, France and the United Kingdom as it has for Germany against the United States and Japan, since their inflation rates have been much higher than Germany's inflation.

The key question is whether the improved international price competitiveness has led to a rise in foreign demand for European products. Fortunately, there is already hard evidence that European export demand picked up in 1981, which is significant since world trade was stagnant in volume terms last year. For example, merchandise export volumes rose by 7.2 percent in Germany, 5.3 percent in Italy and 4.0 percent in France in 1981. As cited above, the European economy showed a modest rise in late 1981, but this has not been sustained. Thus the pickup in export demand during 1981 did help the European economy to emerge from recession, but the recovery has been very weak due to the persistence of depressed domestic demand. Moreover, more recent evidence shows that European export demand weakened in early 1982 due to the widening world recession and coupled with stagnant domestic demand caused a renewed downturn in the overall European economy in early 1982.

FIGURE 12


GERMANY - RELATIVE EXPORT PRICES
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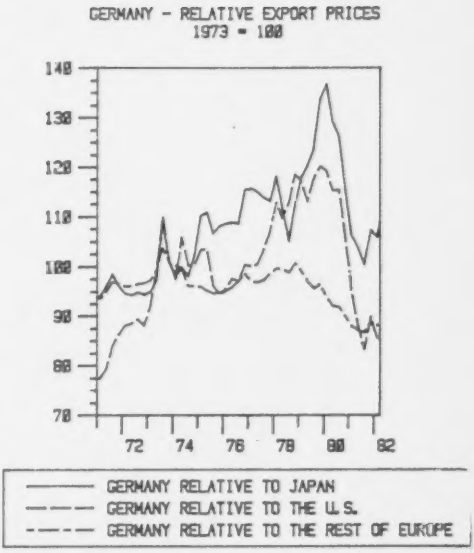
GERMANY RELATIVE TO THE REST OF EUROPE


GERMANY - RELATIVE EXPORT PRICES
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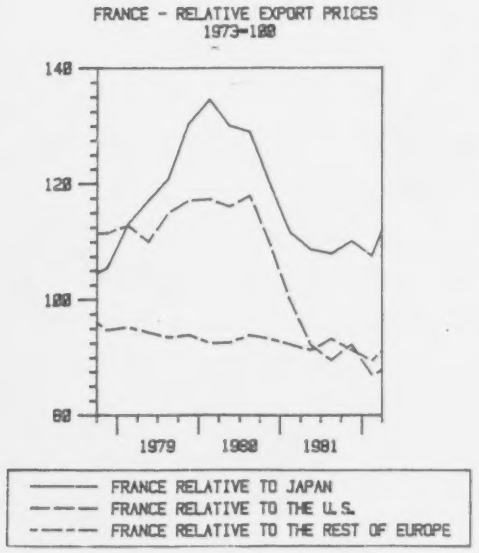
GERMANY RELATIVE TO THE REST OF EUROPE


FRANCE - RELATIVE EXPORT PRICES
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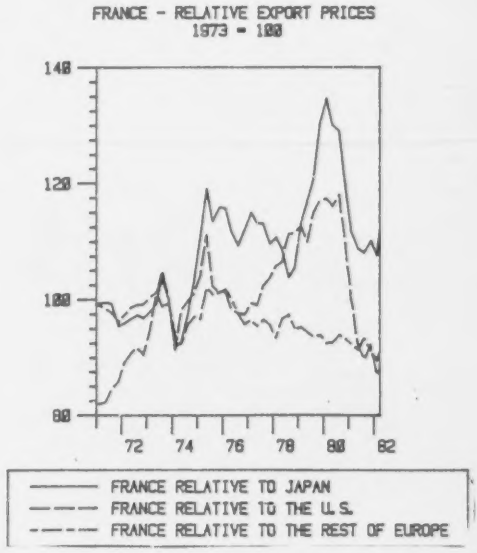
FRANCE RELATIVE TO THE U.S.
FRANCE RELATIVE TO THE REST OF EUROPE


FRANCE - RELATIVE EXPORT PRICES
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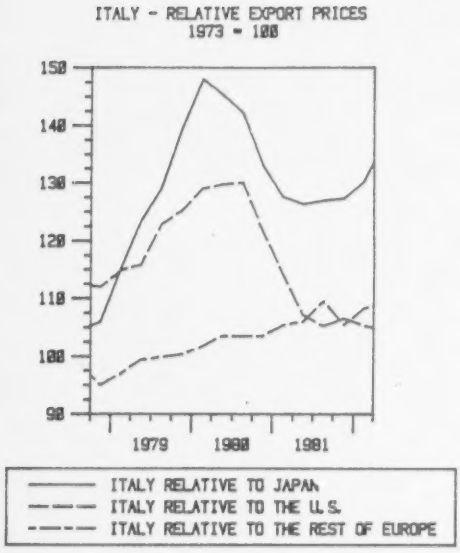
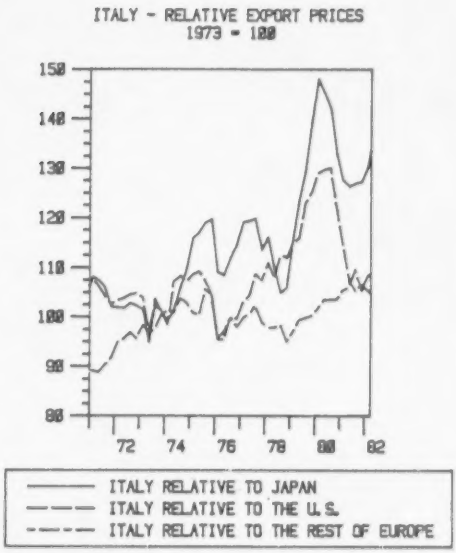
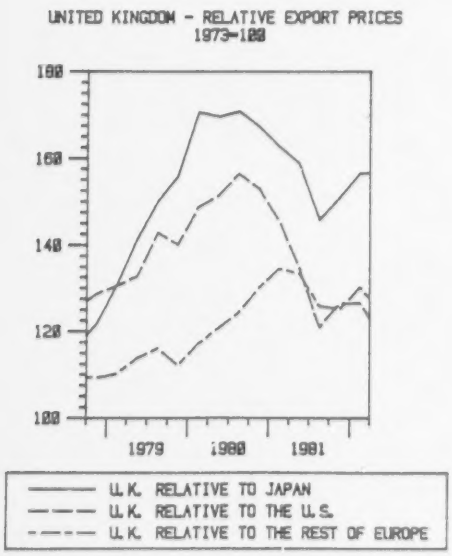
FRANCE RELATIVE TO JAPAN
FRANCE RELATIVE TO THE U.S.
FRANCE RELATIVE TO THE REST OF EUROPE

FIGURE 13







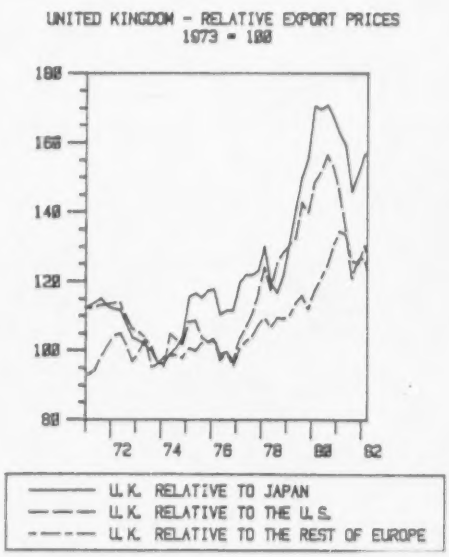


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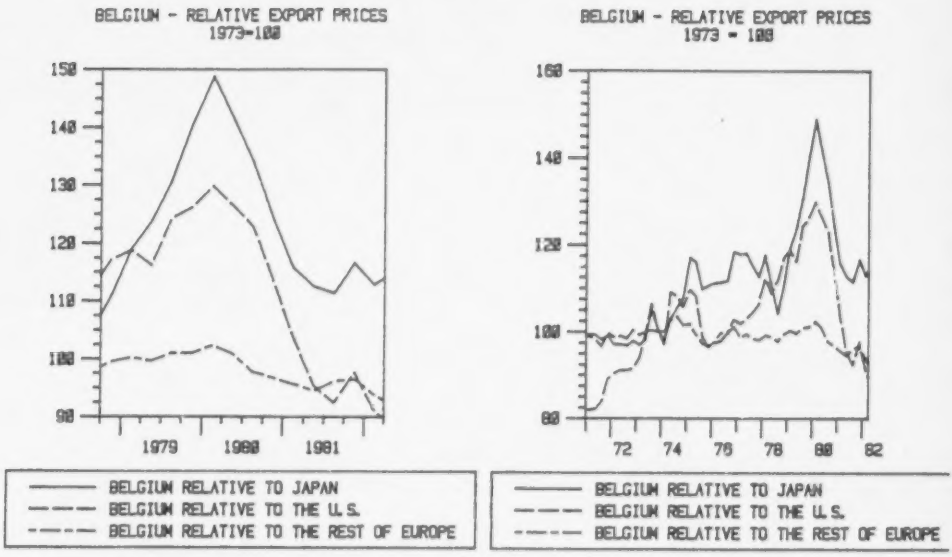
FIGURE 14


BELGIUM - RELATIVE EXPORT PRICES
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120
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90
1979
1980
1981
BELGIUM RELATIVE TO JAPAN
BELGIUM RELATIVE TO THE U.S.
BELGIUM RELATIVE TO THE REST OF EUROPE
BELGIUM - RELATIVE EXPORT PRICES
1973 = 100
160
140
120
100
80
72
74
76
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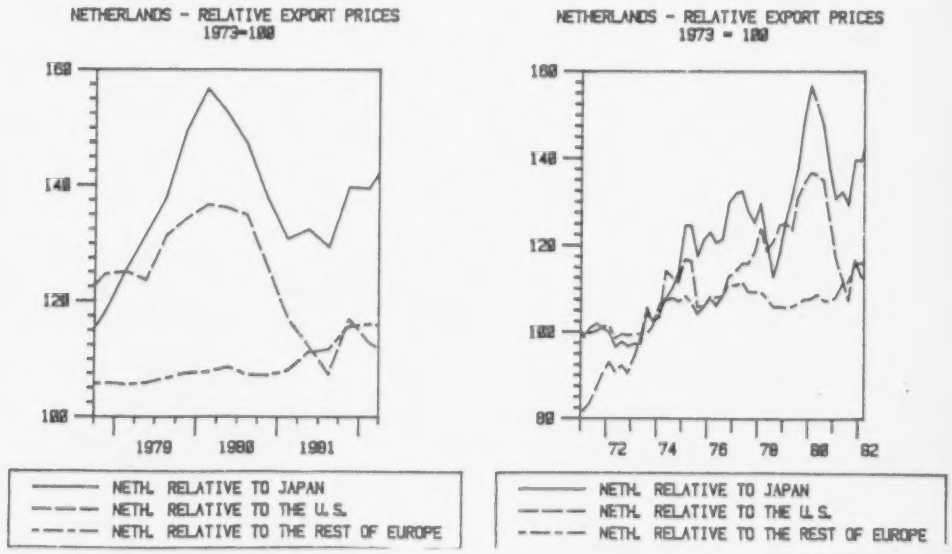
BELGIUM RELATIVE TO JAPAN
BELGIUM RELATIVE TO THE U.S.
BELGIUM RELATIVE TO THE REST OF EUROPE


NETHERLANDS - RELATIVE EXPORT PRICES
1973=100
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1980
1981
NETH. RELATIVE TO JAPAN
NETH. RELATIVE TO THE U.S.
NETH. RELATIVE TO THE REST OF EUROPE
NETHERLANDS - RELATIVE EXPORT PRICES
1973 = 100
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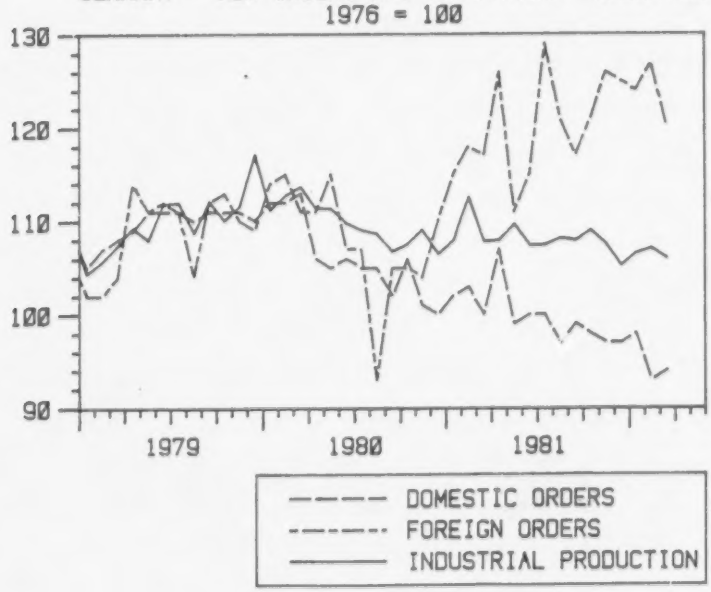
NETH. RELATIVE TO JAPAN
NETH. RELATIVE TO THE U.S.
NETH. RELATIVE TO THE REST OF EUROPE

The experience of Germany is noteworthy, particularly in view of the importance of Germany to the rest of Europe. As explained above, German international price competitiveness improved substantially since the start of 1980, and this caused a significant rebound in foreign orders at about the middle of 1980 (Figure 15). Export deliveries picked up in early 1981, and continued to rise at a rapid pace for the remainder of the year. The substantial gain in exports would have had a powerful effect on overall economic activity in more normal periods of domestic demand. However, domestic demand declined throughout 1981, and this offset the rise in exports. The widening of the world recession in the latter part of 1981, particularly the weaker activity in the LDCs, has dampened demand for German goods as reflected in German foreign orders remaining flat since the middle of 1981. In addition, domestic business confidence failed to pick up in late 1981 and early 1982, which we attribute partly to the persistence of exceptionally high interest rates.

FIGURE 15

GERMANY - NEW ORDERS AND INDUSTRIAL PRODUCTION
1976 = 100



However, we do not believe a decline in U.S. interest rates is a panacea for the European economy. To the contrary, structural difficulties are likely to beset the European economies even if U.S. interest rates would fall. **First,** we are doubtful that European governments will have much success in reducing budget deficits primarily because of the commitments to social welfare and the prospects for continuing high levels of unemployment. **Second,** the wide divergence in inflation in recent years is likely to persist. Germany, Belgium and The Netherlands are expected to succeed in reducing inflation over the medium term, but the United Kingdom, France, Italy, Spain and Sweden are expected to remain well into the double-digit range. The lack of convergence of inflation rates will contribute to pressure on the EMS currencies and monetary instability, although not to as great an extent as in the past if currency adjustments are more frequent as we expect. **Third,** the European countries as a whole have not taken sufficient steps to change their industrial structures to adapt to the likely changes in the world economic environment during the 1980s. Admittedly, energy conservation has progressed quite satisfactorily, although not to the extent it has in Japan and the United States. However, the more important area is the necessary changes to be made in reducing the labor/capital ratio and new product development, areas in which Europe lags far behind Japan. The lack of significant progress in these areas is likely to place Europe in a tenuous position vis-a-vis Japan as well as the newly industrialized economies. **Fourth,** European unemployment will only stop rising, instead of falling, if a cyclical recovery occurs in the 1983-85 period, due to the relatively high growth in the labor force and the high proportion of employment in structurally depressed industries such as iron and steel, textiles, chemicals and shipbuilding.

In summary, the criticism being voiced by European commentators and government leaders over the high U.S. interest rates and the steep appreciation of the dollar is partially merited. High interest rates and a strong dollar have raised European imported inflation, but price reductions for crude oil, other industrial raw materials, and world

food prices have limited the impact of higher import prices on European domestic inflation. On the other hand, the high level of U.S. interest rates has kept European rates higher than desired, which has dampened investment spending and lowered the demand for housing and durable goods. These negative effects have been partially offset by the beneficial effects of improved price competitiveness and the upturn in exports.

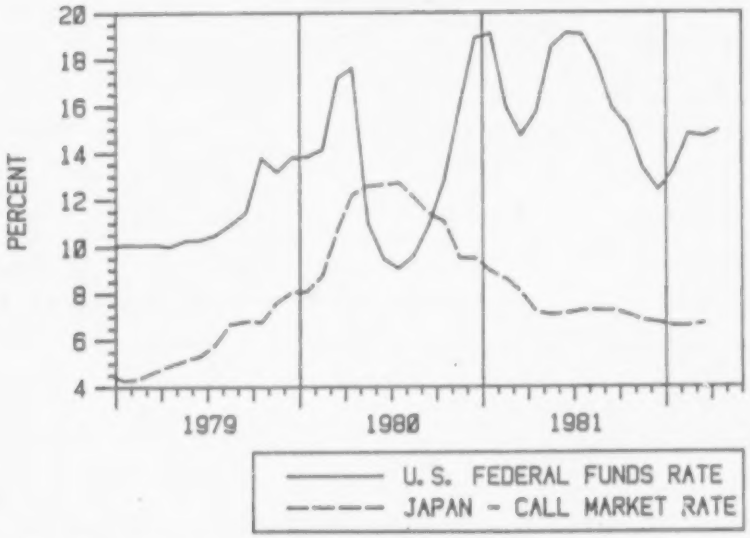
Previous periods of export-led expansion have been followed by a rebound in consumer spending and an improvement in European business confidence. Yet this recovery period is different from previous ones because of exceptionally high interest rates and a number of serious structural difficulties besetting the European economies. Moreover, the climate for world trade has deteriorated in recent months, and this threatens to cut off Europe's only positive source of growth.

Thus, while we believe a decline in U.S. interest rates is important for the European economy and would give at least a moderate boost to European domestic demand, lower U.S. interest rates are not the only cure for the economic problems of Western Europe. Nonetheless, we do support a change in direction of U.S. policies that would lead to lower U.S. interest rates. Such a change would have its greatest impact on the German economy where the easing of monetary policy has been severely restrained by U.S. policy. Substantially lower German interest rates would stimulate German domestic demand, which would give a boost to import demand and the economies of Germany's major trading partners.

Japan. The economic consequence of U.S. policies on Japan are similar to Europe in two respects. **First,** as shown in an earlier table, Japan also experienced a rise in imported inflation concomitantly with the rise in the U.S. dollar against the Japanese yen. Yet in contrast to the experience of Western Europe, Japanese inflation has been exceptionally low due to (a) low wage gains, (b) high productivity gains, (c) energy conservation, and (d) the significant increase in the capital/labor ratio in recent years.

Second, Japanese monetary policy has also been compromised by U.S. monetary policy. Japanese interest rates were raised in early 1979 following the second oil price shock. However, they have been declining steadily since mid-1980, and a much more significant decline would have occurred if U.S. interest rates had been lower (Figure 16). The high level of both nominal and real rates of interest had a significant impact on domestic demand over the past two years. In addition, fiscal policy has been restrictive in an attempt to reduce the very large budget deficits, which has also contributed to the weak state of domestic demand.

FIGURE 16
JAPAN - UNITED STATES
INTEREST RATE COMPARISON



The distinctive feature of the Japanese economy over the past two years is that in spite of the higher imported inflation and higher-than-desired interest rates, the economy has not experienced recessionary conditions as have other industrialized nations. This is reflected in real GNE growing by 4.2 percent in 1980 and 3.0 percent in

1981. This stellar performance stemmed almost entirely from exports which rose at an annual rate of 18.7 percent in 1980 and 16.8 percent in 1981 (Table 4).

TABLE 4

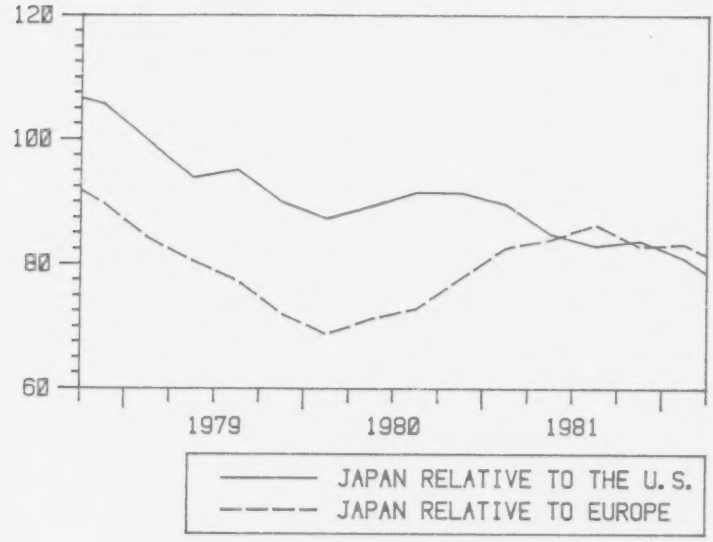
COMPOSITION OF REAL GROWTH
(First Difference - Billions of 1975 Yen)

	1978	1979	1980	1981
Real GNE (Change)	8.3	8.9	7.6	5.6
Contribution From:				
Domestic Demand	9.7	10.8	1.1	1.4
Private	6.3	9.9	1.8	0.0
Government	3.4	0.9	-0.7	1.4
Foreign Demand	-1.4	-1.9	6.5	4.0

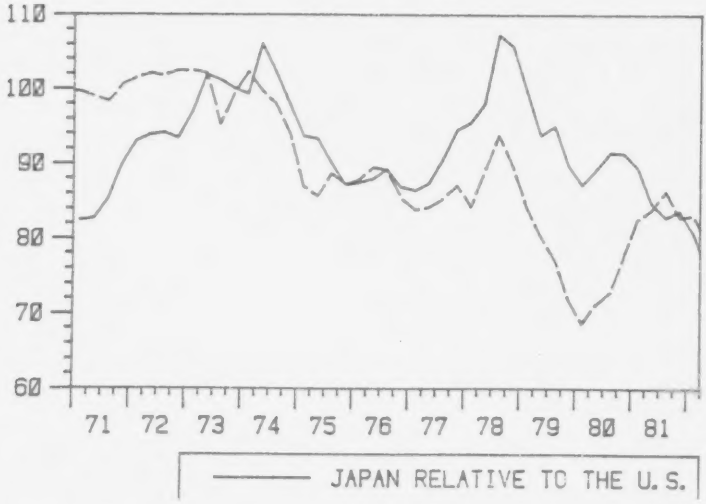
The strength of exports can be attributed to numerous factors such as superior worldwide marketing capabilities, new product development, on-time delivery and effective after-sales service, but a major factor has been the weak yen which has widened the competitive advantage enjoyed by Japan as a result of its lower wages and superior productivity (Figure 17). Yet the tremendous export success Japan enjoyed in 1980 and 1981 has fueled protectionist measures, particularly in the United States and Western Europe. Thus high U.S. interest rates have placed Japanese authorities in a dilemma. The government could stimulate the economy by lowering interest rates, but this would weaken the yen unless U.S. interest rates fell. However, a cheaper yen would put Japan in an even more competitive position which would exacerbate trade tensions.

FIGURE 17

JAPAN - RELATIVE EXPORT PRICES
1973=100



JAPAN - RELATIVE EXPORT PRICES
1973 = 100



Canada. The economic consequences for Canada are relatively straightforward. The Canadian economy is closely linked to the U.S. economy, as the overwhelming majority of Canadians live within 100 miles of the U.S. border. Exports account for 30 percent of Canadian GNP, and two-thirds go to the United States. Financial markets are closely linked, and the fortunes of Canadian corporations are closely tied to U.S. corporate activity via the large foreign direct investment in Canada by U.S. companies. So when the United States prospers, so does Canada. And when the United States slumps, Canada must slump as well. Thus, 1981 was a year of positive growth for Canada as well as the United States. Export prospects for 1982 looked reasonably bright several months ago, but pessimism has been increasing due to the U.S. recession, particularly the slump in the U.S. housing and autos industries that has caused depressed activities in Canadian forestry and mining sectors. Domestic demand has also weakened recently due in part to high interest rates, the downturn in exports and the negative psychological impact of the U.S. recession. Given a choice, Canada would have lowered interest rates, if U.S. policy were different. However, due to the close financial links between the two economies, the Bank of Canada has been forced to maintain interest differentials to prevent a sharp decline in the Canadian dollar (Figure 18). Yet the high level of Canadian inflation has also contributed to the tight monetary policy in Canada. It is also fair to mention that a good share of Canada's problems are related to the poor management-labor climate and resulting high wage settlements in the unionized industries, and the confused state of federal and provincial policies on energy and business taxation.

FIGURE 18

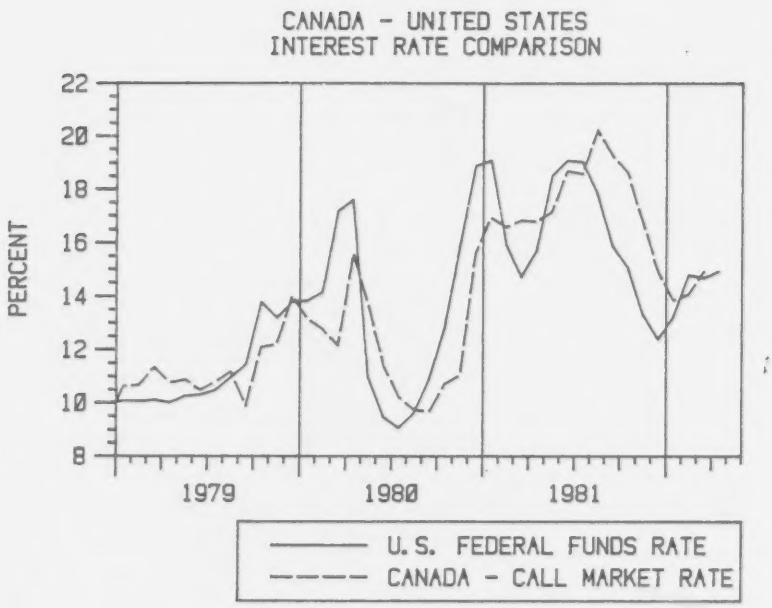
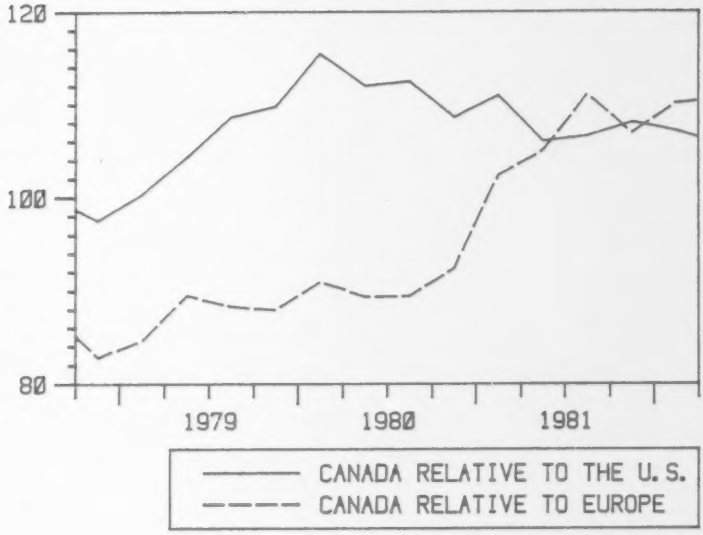

CANADA - UNITED STATES
INTEREST RATE COMPARISON
PERCENT
22
20
18
16
14
12
10
8
1979
1980
1981
U.S. FEDERAL FUNDS RATE
CANADA - CALL MARKET RATE

FIGURE 19

CANADA - RELATIVE EXPORT PRICES
1973=100



CANADA - RELATIVE EXPORT PRICES
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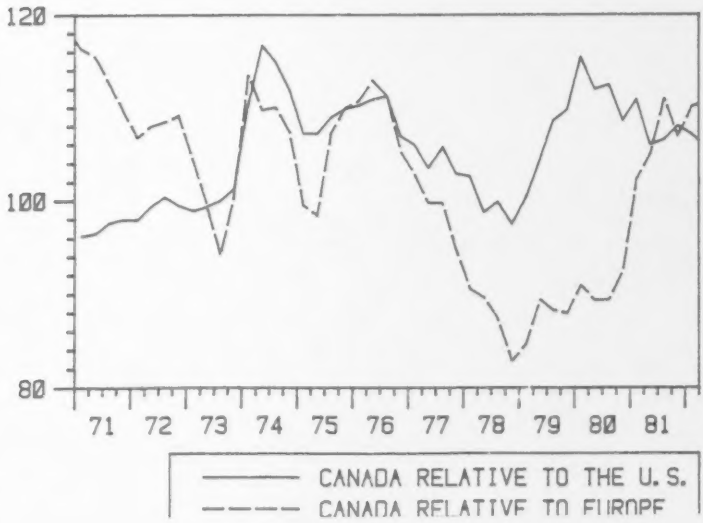


Impact on the Developing Countries

To understand the impact of U.S. policies on developing countries it is first necessary to establish the importance of the interaction between developing countries and the world economy and then to determine whether the U.S. economic developments have had any additional impact on the developing countries performance over and above the U.S. influence on world economic conditions at large.

Trade. The economic performance of developing countries is clearly influenced by their exports. Non-oil developing countries[1] real gross domestic product growth rate has slowed down from an annual rate of 5.1 percent in 1979 to 4.8 percent in 1980 and 2.5 percent in 1981, partly in response to a decline in their export volume growth which expanded 9.4 percent in 1979, 5.6 percent in 1980 and 3.1 percent in 1981.

During this period the U.S. market has represented an almost constant share of developing countries (non-oil) exports in the range of 26%, indicating that the slowdown of U.S. imports from developing countries has not been significantly different than the demand slowdown experienced in other areas for developing countries products. The declining growth of developing country exports, in particular, commodities—which represent 60% of their total export revenues—has been caused by the slowdown in developed countries economic activity and by a reduction in commodity stock holdings triggered by historically high interest rates. Consequently, on this account, the degree

---

[1] Non-oil developing countries include all International Monetary Fund members except those listed as industrialized countries or oil exporting countries. Oil exporting countries include Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Onan, Qater, Saudi Arabia, United Arab Emirates, Venezuela.

of the U.S. economic policies impact on developing countries performance can only be assessed by the impact those policies have had on these two major variables, world economic activity and interest rates.

TABLE 5

NON-OIL LDC GROWTH VS. EXPORT ACTIVITY
(annual percentage change)

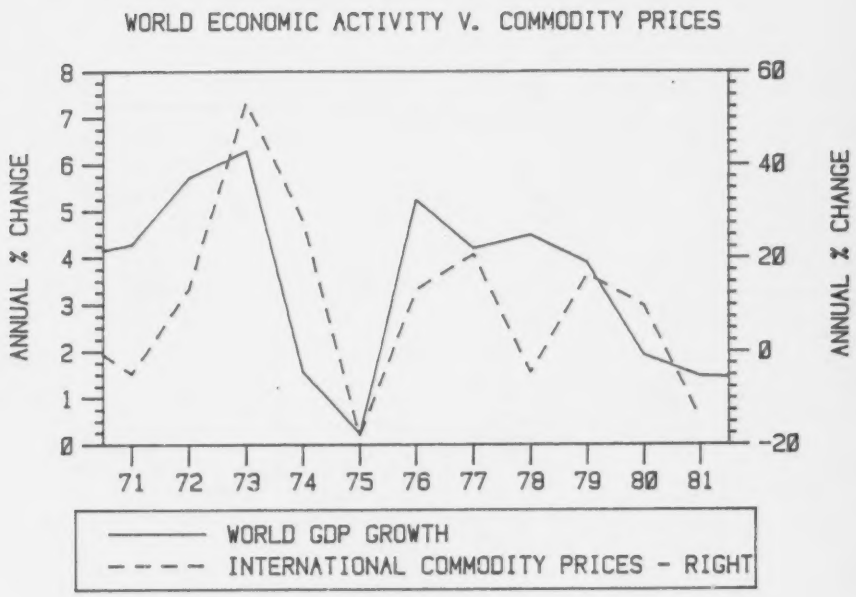
	Real GDP	Export Volume
1978	6.5	9.5
1979	5.1	9.4
1980	4.8	5.6
1981	2.5	3.1

Source: International Monetary Fund, 1982.

Commodity Prices. Non-oil developing countries' export revenues in dollar terms expanded at a rate of merely 5.7% in 1981 down from 26.4% in 1980, contributing to the continuation of their current account deficits and a reduction of export tax revenues which had a detrimental impact on growth. Beside the reduction in export volumes discussed above, the slowdown in export revenues has been caused by declining commodity prices. The IMF commodity price indices for metals and agricultural products showed a 13.6% and 9.8% decline in 1981, the first such reductions since 1975.

The specific impact of U.S. policies on these developments is again via the impact of those policies on world economic activity and interest rates, aside from isolated cases such as tin and silver for example, where the U.S. policy of reduction in government stocks may have had an additional downward effect on those commodity prices (Figure 20).

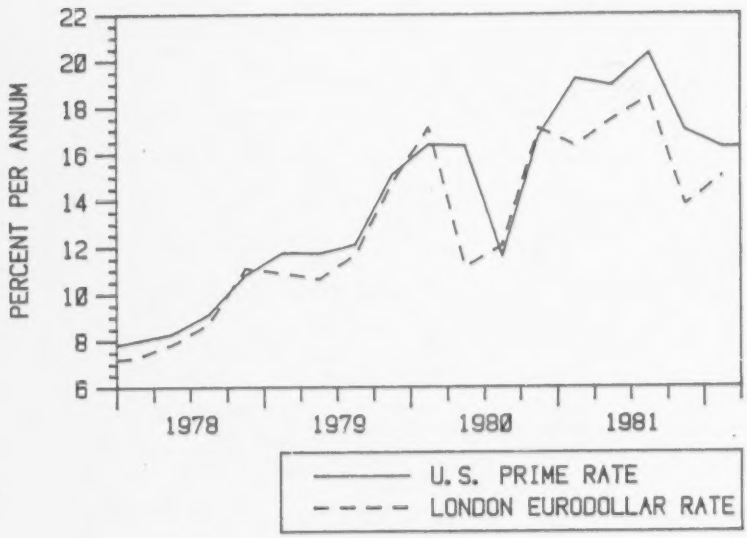
FIGURE 20



Interest Rates. Developing countries have become more vulnerable to higher costs of funds in international markets during the past several years. Developing countries' medium- and long-term debt has increased rapidly over the past decade from $104 billion in 1973 to $293 billion in 1978 and a reported $521 billion in 1981 (Figure 21). This increase in indebtedness has been accompanied by an average reduction in the maturity of the debt and by an increase in the share of debt outstanding to commercial financial institutions (presently at approximately 45%). These two developments have implied that amortization payments on the foreign debt principal have increased rapidly and that an increasing share of the debt has been contracted at market non-concessional interest rates.

FIGURE 21

INTERNATIONAL INTEREST RATES



Higher costs of foreign funds for developing countries—which can be measured by the Eurodollar London Interbank Offered Rate (LIBOR)—have implied larger interest payments on the external debt, with the consequence that an increasing share of non-oil developing countries export revenues has been devoted to pay for amortization and interest on their external debt. This share—known as debt service ratio—has increased from 14% in 1973 to 21% in 1981 on average, but has risen more rapidly for some of the larger borrowers, impairing their debt management capacity and their ability to continue to rely on foreign savings to sustain high rates of growth. Developing countries that have reached critical foreign indebtedness levels during the past year have pursued restrictive fiscal and monetary policies aimed at improving their current account deficits by reducing the growth in economic activity and imports requirements.

In addition, the surge in world financial market interest rates has had a broader basis effect on developing countries by forcing in many cases upward adjustments in domestic interest rates—triggered in many occassions by the need to prevent outflows of foreign currency reserves. Higher interest rates in the LDCs have discouraged investment and consumer durable goods expenditures, much the same as the process in the industrialized nations. However, these adjustments have been somewhat beneficial in many countries since the higher interest rates effectively removed interest rate subsidies resulting in an improved resource allocation process.

The impact of U.S. monetary policies on the LDCs is rather direct since there exists a strong correlation between U.S. commercial interest rates and LIBOR rates and the borrowing costs of the LDCs.

The Strong Dollar. The U.S. dollar strength vis-a-vis other major industrialized countries currencies has implied that developing countries which have customarily set their currency exchange rate in relation to the U.S. dollar have tended to lose competitiveness in other currency area markets. The detrimental impact in terms of lost export revenues and increased imports for non-oil developing countries is difficult to assess. In many cases developing countries have attempted to offset such disadvantage by accelerating the pace of their devaluation vis-a-vis the U.S. dollar. An indirect effect of this measure, however, has been additional domestic inflationary pressures and higher domestic currency costs of foreign funds which have contributed to the pressure for domestic interest rates upward movements.

Representative REUSS. Thank you, Mr. Norris.

I am struck by the fact that all three witnesses, if they were at the summit, would advocate a solution which would start with lower interest rates in the United States, obtained by a tighter fiscal policy and a somewhat less restrictive monetary policy, and you then would look for some linkage. You would look for progress on a unified East-West policy with the Europeans; you would look for Japanese budgetary actions which would somewhat strengthen the yen and thus reduce Japanese export penetration in Europe and the United States; and you would look for somewhat less unhappy days for the less-developed countries.

Mr. Rashish doesn't think that any of these good things are going to happen, and indeed he perceives that the Europeans aren't going to be very obstreperous about even raising them.

I'd like to ask Mr. Cooper and Mr. Norris what your hunch is as to whether the summit is going to achieve anything or not.

Mr. COOPER. I'm not sure it's especially useful for somebody from the academic community to forecast political events of this kind. If I were a betting man I'd guess I'd have to say it's a long shot that this will be a summit that will be successful in terms of the kind of package deal that I laid out.

I do think, quite apart from the possibilities of an agreement reached there along those lines, to some of which I would attach a low probability, I think the Europeans would make a serious mistake not to raise these issues at the summit, even though they might have no expectations of achieving agreement.

The President is said to be a good listener; he is said to be educable. I fear that he came away from the Ottawa summit with his views intact because the foreigners did pull their punches for perhaps understandable reasons. I think if they pull their punches again, he will not have been impressed with the deep feelings that run elsewhere in the world about U.S. policy.

Representative REUSS. What is your hunch?

Mr. NORRIS. Well, I'm not very optimistic that major successes will stem from the Versailles meeting. I believe the administration has its policy more or less cast in stone, at least if not stone, concrete. The best I can hope is that the Europeans and the Japanese and the Canadians will convey upon President Reagan the consequences of our policies.

And I hope there are some individuals speaking on behalf of the poor nations, because, as I have indicated, I believe the consequences of our policies, the cost of our policies, have been quite severe. And my hope would be that the Europeans are persuasive in their arguments with President Reagan. I am not very optimistic that we will be good listeners in Versailles.

I might add that I think the problem has festered too long to expect immediate solutions. Mistakes were made perhaps 1 year or 2 years ago here in Washington, and I might use the same arguments for Government leaders in Tokyo, Paris, Bonn, and so on. But particularly here in Washington, it is my opinion that Government leaders have failed to understand the international consequences of our policy actions.

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Would we have tolerated 10 or 15 percent real rates of interest? Would we have tolerated a dollar today that is stronger than it was in 1970? And would the Europeans, if they were brought into the decisionmaking process or collaborative process, have accepted these consequences?

And I think that what we probably should be striving for is not that this Versailles conference is a success but rather that we understand more fully the international consequences of our actions here in the United States, in Japan, and in Western Europe.

It is only then, I believe, that we can achieve a greater degree of cooperation and set forth the policies that will lead to stable and lower inflationary growth.

Representative REUSS. All three members of the panel, it seems to me, agree that high interest rates in the United States and a loose fiscal and tight monetary policy are at least in part responsible for world troubles. All agree that the likelihood is that nothing much is going to happen at the summit.

There is a difference, I think, between Mr. Rashish on the one hand and Mr. Cooper and Mr. Norris on the other, in that Mr. Rashish feels that maybe it is just as well that our summit partners are going to be well-behaved and not critical of the United States at the summit because it would be unseemly to have deep-felt disagreements surface at the summit.

Mr. Cooper and Mr. Norris, on the other hand, seem to feel that it would be better if our partners did speak out and lay it on the table and that the world is capable of absorbing the repercussions of such a disagreement.

Did I misrepresent you, Mr. Rashish?

Mr. RASHISH. Just a trifle, a trifle.

Representative REUSS. I didn't mean to but straighten the record out.

Mr. RASHISH. I think what I was suggesting was the nature of summits, the commitment of the leaders meeting at this elevated level to avoid open, flagrant disagreement, kind of the exigency of the requirement for success, in quotes, and from what we know about the run up to the summit, the surrogate meetings, OECD ministerial, the IMF interim committees, all suggests that these disagreements are likely to be muted. It isn't that it is inappropriate to have contention in the summit, to have these issues argued out, or that it would be unseemly to do so. It is simply that the constraints of summitry are such that it is unlikely that there will be a high contention quotient at the summit.

Representative REUSS. I am glad to have you make this explanation because I gather, then, that while you think that it will be a circumspect summit, without vigorous public disagreement, in your heart of hearts it wouldn't bother you if it were a less than completely placid and agreeable summit.

Mr. RASHISH. I think serious problems ought to be treated seriously, and I think we have a serious problem at the moment, and I think the leaders ought to address them seriously. If dealing with serious issues involves the airing of disagreement, all the better.

Representative REUSS. Mr. Cooper.

Mr. COOPER. I didn't want to leave the impression from your summary that I was in favor of bad behavior by the others at the summit.

I am always in favor of good behavior. But I think the other leaders would be remiss, actually, not to state what is on their mind, and that could be done in a noncontentious way. It can be done without getting into a fight, without realistically, I think, expecting the United States at the summit to agree to change its course of action, but use it as an educational forum.

There is, as you more than most are aware of, the special problem of the United States that monetary policy is not controlled by the administration; it is in the hands of the Federal Reserve. So on the issue which is of most concern to other countries, in any case the President could not make a commitment.

So it seems to me it could be done in a firm and educative but noncontentious way, and I would hope the President would come away with a better appreciation about some of the external consequences, not just economic consequences but consequences for the cohesion of the alliance, our relations with our friends, that arise out of economic policy.

FEDERAL RESERVE SHOULD BE MORE RESPONSIBLE TO CONGRESS

I think that one has to look, if I can just add a point, not to the Versailles summit, but to the Congress for greater discipline on the Federal Reserve. It is made clear time and again, especially in these times, that it is not responsible to the administration but is ultimately responsible to the Congress. And this is where the direction must come for change in policy. The Board and the Open Market Committee interpret what they think is sensible and ultimately acceptable policy by the Federal Reserve. And if they are wrong in that, this is the body which should set them right.

Representative REUSS. I would say while I agree with you that the Federal Reserve is and ought to be independent of the Executive but responsible to the Congress, nevertheless the Executive has been cheering on the Fed in its monetary policy, and it certainly wouldn't hurt to have a suggestion that it should stop cheering the Fed on.

Mr. COOPER. It wouldn't hurt, but it wouldn't do as much good, I think, as if stronger action were wafted across the horizon by this body.

Representative REUSS. I think this is an important thing we are discussing, the question of whether controversy should be banned at summit meetings, and I'm glad that none of the three witnesses feel it should be.

Did you have something more to suggest?

AVOID "BEGGAR THY NEIGHBOR" POLICIES

Mr. RASHISH. I made a rather, I thought, subtle point which might bear repetition. It seems to me that the industrialized countries of the world have learned very well the lesson of the 1930's, which was that they should in their national policies avoid "beggar thy neighbor" policies, try to palm off, as it were, their recessions on others, the classic case of the 1930's.

I pointed out that the nature of the world has changed a great deal since that time, that we are now a great deal more interdependent

than we have ever been before. And to manage this kind of a system, governments not only should avoid those policies which constitute "beggar thy neighbor" practices, but affirmatively they have to adjust their policies in light of the exigencies of living in so interconnected and interrelated a world.

With respect to the issues which are on the agenda of the Versailles summit, it isn't as if the rest of the world is asking the United States to do things that are contrary to the self-interest of the United States. No one is keen about high interest rates or low levels of economic activity or high and volatile exchange rates on the part of the United States. It seems to me that there has been a political process at work over these last few months which you and the Congress have been intimately engaged in, as evidenced by the various budget resolutions you are voting on currently, to try to reshape that budget largely for domestic, political, economic reasons.

The subtle point I was making is that the President of the United States is the leader of the system and, as the constitutional custodian for foreign policy, has a weapon in his hands, an instrument of policy, to use in shaping and influencing that internal political debate about what kind of an economic policy we should pursue, what kind of a policy mix we should have. And that is an instrument that has not been used. That is the point Mr. Norris made earlier, I think.

Representative REUSS. It is a point that, though subtle, I think is very valid, and what it boils down to is that the President shouldn't refrain from doing what is good and sensible for our own economy just because it's good and sensible for the rest of the world, too.

Mr. RASHISH. But if it's good and sensible for the rest of the world, there are certain foreign policy exigencies he can exploit and use more efficiently to achieve the desired result.

Representative REUSS. My time is up.

Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Cooper, I am certainly interested in your testimony this morning. You suggested that at the Versailles conference everyone should denounce protectionism and agree free trade is the way that we cure the current international depression; correct?

Mr. COOPER. That would be an overstatement of what I said. We have built a liberal trading system. It still falls far short of being a free trade system. What I am arguing here is that we run a substantial risk at the present time of backsliding, of losing that, and it's really the point that Rashish was making; that would be "beggar thy neighbor."

JAPAN MOST PROTECTIONIST INDUSTRIAL COUNTRY

Representative RICHMOND. Professor Cooper, I think it has occurred to you that the one country which talks free trade and is the most protectionist country in modern times is Japan, which will be the greatest superpower in the entire world in the year 1983. As you know, they will outproduce every other country in the world on industrial goods next year. They are protectionists. They talk. Their scheme is to talk everything to death and to do nothing. And as you know, if they have to do anything toward true free trade, the Liberal Democratic Party will no longer be the Government in power. Therefore,

you know, no matter how much you talk at the Versailles conference, the one major threat you have there of really destroying free trade is from Japan. And you know there has been a lot of talk. Nothing will ever happen.

I wish someone would give us a remedy for how we are going to get the Japanese to treat the rest of the world not as colonies but as equals.

Mr. COOPER. I have a rather different interpretation of Japan's policy than your remarks suggest.

U.S. EXPORTS TO JAPAN DO NOT CREATE EMPLOYMENT

Representative RICHMOND. You do know our deficit balance of trade is growing by leaps and bounds. You know that the quality of the deficit is the sickest thing that is happening to the United States, the fact that the Japanese ship us "beads and whiskey" and we ship them back nonrenewable resources. They ship us goods which we can live without very nicely in exchange for our own natural resources. How are we ever going to correct the quality of trade unless we get the Japanese to recognize what they are doing to us?

Mr. COOPER. This is the first time I have heard it suggested that exports of either high technology products, like civil aircraft, or agricultural products——

Representative RICHMOND. Professor Cooper, they are not buying agricultural products; they are buying raw materials. They won't buy our processed goods.

Mr. COOPER. They are buying some enormous numbers of agricultural products.

Representative RICHMOND. On every bushel of corn we ship out we are losing money; on every bushel of wheat we ship out we are losing money; on every bushel of soybeans we ship out we are losing money.

Mr. COOPER. That's not because of Japanese policy. The point is they are not nonrenewable products. These are renewable products. They are high-quality products which normally produce income in the agricultural sector.

Representative RICHMOND. Phosphates, copper ore, wheat, corn, soybeans, and coal are nonrenewable natural resources. Every time you ship a bushel of corn, you are also shipping some topsoil.

Mr. COOPER. In which sense is shipping a bushel of corn nonrenewable and shipping an automobile renewable? The steel and coal comes from U.S. mines.

Representative RICHMOND. Exactly. In our country it creates employment.

Mr. COOPER. So does corn.

Representative RICHMOND. No, unfortunately corn doesn't create employment because one person can produce corn, and we lose so much topsoil along with it.

Mr. COOPER. Having come from a background of farmers, I am sensitive to the fact that it does create employment. We happen to be very efficient at it.

Representative RICHMOND. Professor Cooper, it creates very little employment, and I submit that the loss of the topsoil is highly significant. But I'm just saying you have to understand and the American people have to understand that the problem we have with the Japanese is not the fact that we have to start with a deficit, but the fact is they won't buy our processed materials which create labor.

IS GOVERNMENT DEFICIT OR FED POLICY PRODUCING THE HIGH INTEREST RATES?

My second question—I see I'm not going to get very far on the first one—apparently your testimony indicates you blame the Federal Reserve for the present fix we're in. Doesn't it occur to you that perhaps if the administration's fiscal policy was somewhat less irresponsible, if we hadn't had these ridiculous tax cuts, if we hadn't been spending so much money on defense, if we had tightened up our budget, if we hadn't been running a budget whose deficit next year will be $185 billion we wouldn't be in the fix we're in. You know as well as that the revenue income next year won't be what everyone expects it to be. If you have a $185 billion deficit—and that is what you're going to have—and the American people only save $200 billion, where is the money for American corporations to retool?

And if the Treasury has to chase every dime of American savings in order to survive, how are you going to reduce interest rates to a point where American industry can afford to retool?

Now, that is not the Federal Reserve Bank. It is the irresponsible policies of the administration—tax cuts when we don't need them; far too much money on defense which we don't need. If this administration had a sound fiscal policy and a relatively balanced budget, interest rates would come down, American corporations could then proceed to compete with the rest of the world. That's your main problem. It's not the Federal Reserve Bank.

Mr. COOPER. I would be the last one to defend the administration's fiscal policies in all its aspects and I certainly do not want my statement to be interpreted by that omission as an endorsement of those policies.

I do, however, disagree strongly with what has become the conventional wisdom on this matter, which is that the core of our overall economic problem is the size of the Government deficit. I think that is an error.

And to put it in strong form, let me put it this way—it's not going to happen, but suppose we were to reduce that deficit for next year from whatever it is, $180 billion, to zero, and the Federal Reserve were not to change its policies, if one could imagine that. I do not think interest rates would come down very much.

Representative RICHMOND. Mr. Cooper, as soon as money is available, interest rates drop.

Mr. COOPER. Let me draw a distinction between short-term interest rates and long-term interest rates which I think is an important one. The Federal Reserve alone determines the amount of money that is available. That, in my judgment, is largely determinative of short-term interest rates. Long-term interest rates are more complicated. And there I would agree entirely that the prospective size of future budget deficits is one of the factors keeping up long-term interest rates, as is concerns about renewal of inflation, and so forth.

But I would argue that the most important influence holding up long-term interest rates at the present time is high short-term interest rates. We will not put to a test the proposition that future expected budget deficits are a major factor or that renewed inflationary situations are an important factor until short-term rates come down.

Representative RICHMOND. Tell me how they can come down when

the Treasury offers 14 percent? How can short-term rates come down below 16 or 17 percent? No way.

Mr. COOPER. We have run proportionately large budget deficits in every recession, and in every other recession short-term interest rates have come way down. And the reason is the Federal Reserve has been more expansionist than it is now being. Business loan demand has slacked way off and that brings short-term interest rates down. And it hasn't come down equally in all recessions. This is the only recession since World War II, and no doubt it would include recessions by generalization before them, in which short-term interest rates have not come down.

Representative RICHMOND. The average businessman just can't possibly amortize his equipment when he has to pay 16, 18 percent interest.

Mr. COOPER. There's no doubt——

Representative RICHMOND. We have an enormous demand. Our machine tool business is off by 50 percent, which is incredible, when our machine tool business theoretically should be up 150 percent over last year. It's 30 percent below last year.

Mr. COOPER. We're saying the same thing. They can't afford the high interest rates.

Representative RICHMOND. They can't afford the high short-term interest rates, which they desperately need. There's no way you will ever amortize a piece of equipment when you have to pay 18 percent interest.

Mr. COOPER. I agree with that. And the question is: What is the reason for the high short-run interest rates?

Representative RICHMOND. Because the Treasury is taking all the available money.

Mr. COOPER. I am asserting that the reason for the high short-term interest rates by comparison with previous recessions in the United States is exceptionally tight monetary policy—exceptionally tight monetary policy. And there's an ambiguity about what you mean by monetary policy. There are a variety of measures, but it is exceptionally tight on all of them. If the Fed were to pursue a policy which were comparable to the policies which were pursued in 1954, in 1958, in 1960, in 1970, and in 1975, short-term interest rates would be very much lower than they are now.

Long-term interest rates, I would expect, would also be somewhat lower, but I admit that that is more of a question mark because you get into the future budget deficits due to its long-term rates. But the main thing that influences long-term rates is short-term rates.

Normally at this stage of economic activity, with the sharp fall in orders that you have mentioned, we should have short-term rates very much lower than long-term rates. The yield structure today is virtually flat. It's an extraordinary phenomenon for a recession.

Representative RICHMOND. Just to answer you, it's because the Treasury has taken all the loose change away.

Mr. COOPER. No, I don't think so.

Representative REUSS. Mr. Norris.

Mr. NORRIS. If I may, I'd like to add a comment to Dick Cooper's comment. Perhaps it's at variance with what he said. I think the Fed could get interest rates down through a variety of means. A lowering of the budget deficit would certainly help. But I'm not all that confident that rates would stay down if the Fed tried to get them down.

The reason I say that is that we are ignoring the tremendous re-

quirements of the less-developed countries. The tremendous rollover that has gone on month by month, quarter by quarter, year by year, is putting tremendous strains on the international financial system, not to mention the increased risk they experience in making loans to these less-developed countries.

And on top of that, budget deficits in Japan, in Germany, in Italy, and in the United Kingdom are proportionately greater, even factoring out relatively higher savings rates, than the budget deficit here in the United States or the next year's or the year after's budget deficit.

So I'm saying that while U.S. monetary policy is very important, it is probably the singlemost important influence in the direction of world interest rates. Again, I think that it is not the only solution to the world economic problems. It is probably the most important solution to our problems here, short-term problems, not to the rest of the world.

Representative REUSS. It is, however, part of the solution.

Mr. NORRIS. Yes, I say it's part of the singlemost important facet of a global solution.

Representative REUSS. Mr. Cooper, did you have something?

Mr. COOPER. I was just going to mention the figure which I take from the economic indicators now which projects the budget deficit for fiscal year 1982, the year we are now in, at $100 billion. I understand there is some controversy about that number, so I suggest it may be a shade lower. But anyhow, take that as an order of magnitude. It's roughly 3 percent of the GNP at the present time. And we ran a deficit in the previous recession—I'm not speaking now of 1980 but of 1975—which was proportionately greater than that. The series I have doesn't go back into the 1960's, but my recollection is that the budget deficit in the 1960's was also proportionately greater than that.

When business loan demand is weak, as it is in a recession, deficits of this magnitude—I am speaking of current deficits—are not scooping up in competition with business. It is the fact that the Federal Reserve is tight.

When one looks out to 1984 and 1985, as I said, it is a completely different picture. There we envisage, and indeed the assumptions of the deficit projections are some recovery in the United States, and I think that is on a nonsustainable path. The deficits just grow extraordinary. So it's the out years, not the current years, that we have to worry about.

Representative REUSS. Mr. Norris.

Mr. NORRIS. Again I'd like to elaborate and comment. The absolute level of the budget deficit or relative level to GNP is important. But really what is equally important is the proportion of available savings or loan funds that the Government is absorbing. And I don't have these statistics readily available, but I believe the Treasury's demand for funds relative to total available funds in the next several years will increase dramatically relative to the past year or two, relative to previous recessions. So that is a very important reason for the current high level of interest rates.

Representative REUSS. I would like to insert at this point in the hearing record a recent letter to me from Representative John Seiberling of Ohio, enclosing a paper by Prof. Harold Williams of Kent State University which is highly relevant to the topic of these hearings.

[The letter and paper referred to follow:]

JOHN F. SEIBERLING
14TH DISTRICT, OHIO

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May 11, 1982

Hon. Henry S. Reuss
Chairman
Joint Economic Committee
G-133 Dirksen Senate Office Building
U.S. House of Representatives
Washington, D.C. 20510

Dear Mr. Chairman:

I am enclosing a copy of a study by Professor Harold Williams, Director of the International Business Program at Kent State University, on the effects of our restrictive monetary policy on the U.S. auto industry.

As you will note, Professor Williams' basic point (on pages 3 and 4 of the study) is that high interest rates have strengthened the dollar on the international market to the point where foreign car imports are able to enjoy a significant ($700-$1,500) price advantage over comparable U.S. car models. According to Professor Williams, the strong dollar "has reduced the price of Japanese automobiles to American consumers and hence caused Japanese auto sales in the U.S. to be significantly above what they otherwise would have been."

It follows that one key to a revived U.S. auto industry is to lower the value of the dollar relative to the yen. This simply emphasizes further the havoc resulting from our continued high interest rates and the urgency of significant reductions in the federal deficit projections for 1983 and beyond.

I believe you will find Professor Williams' study of interest.

Best regards,

Sincerely,

JOHN F. SEIBERLING
Member of Congress

JFS:nm
Enclosure

THIS STATIONERY PRINTED ON PAPER MADE WITH RECYCLED FIBERS

Monetary Policy, Exchange Rates, and U.S. Automobile Imports from Japan

By Dr. Harold R. Williams*
Kent State University

Restrictive monetary policy of the degree currently in effect in the U.S. adversely affects the economy in two major ways. First, by increasing interest rates and reducing the availability of money it has a significant negative impact on many industries, including housing, steel, automobiles, rubber, and major durable consumer appliances. The higher the interest rates and the less the money available for lending, the greater is the adverse impact. The depressive effect is especially strong when interest rates approach levels that are high by historical standards and high in real terms. Given the severity of the current U.S. recession,[1] this negative effect of high interest rates is sufficient by itself to justify arguing for a substantially easier monetary policy.[2] Note that the extremely tight monetary policy--in the context of the current economic conditions in the U.S. and international economy--not only lowers or slows the growth of aggregate demand but also by discouraging business investment, slows modernization, capital formation, productivity, and production.[3]

The second major way monetary policy affects the U.S. economy is via its effect on exchange rates. Under a floating exchange rate system changes in monetary policy cause movements of the rate of exchange that alter the competitive position of U.S. exporters and importers--

the resultant exchange rate change alters the ability of domestic producers to compete pricewise with foreign producers of like or similar products. A restrictive monetary policy, all other things held constant, appreciates the U.S. dollar on the international market and thereby reduces the cost to Americans of imports while increasing the cost of American products to foreigners. It thus tends to increase imports and reduce exports, causing or tending to cause a balance of trade deficit.

More specifically, when monetary policy is tightened so much that it causes the level of U.S. interest rates to increase significantly relative to interest rates of other nations, foreign capital flows to the U.S. to take advantage of the higher interest return. To invest in the U.S. the foreigners in effect buy dollars on the international foreign exchange market. This increased demand for dollars causes the dollar to appreciate in terms of other currencies.[4] The result is that the U.S. dollar now buys more foreign money than previously and hence for Americans the foreign products are less expensive than was the case before the dollar appreciated. Since imports are less expensive, Americans will tend to buy more foreign products and less domestic products--foreign products will be substituted for similar domestic ones. By the same token, the strong American dollar discourages U.S. exports because foreigners now have to give more of their money to get the dollars which they need to buy the U.S. products. The stronger dollar, which in this case is due to the high U.S. interest rates, cuts into American exports, encourages imports, and causes a deterioration in the U.S. balance of trade.[5]

The impact of monetary policy on international trade, and the magnitude of the impact, can be illustrated by showing how current U.S. tight money policy sets into motion forces that affect U.S. imports of Japanese automobiles. To keep the presentation concise and readily understandable there is no attempt at full exposition or justification of the assumptions and theoretical relationships implicit in the analysis. Assume, as appears generally accepted, that at the present exchange rate between the U.S. dollar and Japanese yen of $1 = ¥246 the average American car costs from $700 (for the basic smaller models) to $1500 more (for the more luxurious models) than the comparable Japanese car. Our example uses the Toyota Corolla Deluxe two-door which currently lists for about $6500. Assume also, as is widely agreed, that the U.S. dollar is currently overvalued compared to the Japanese yen and further that the fundamental equilibrium level is in the range of ¥190 - ¥210.[6] Finally, assume the Japanese yen cost of the 1982 Toyota Corolla is about ¥1,600,000.

Table I shows how a more realistic exchange rate between the dollar and yen affects the price advantage of Japanese automobile sellers. At the present exchange rate of $1 = ¥246, the American price in dollars for the basic Toyota Corolla is about $6,500,. If the U.S. dollar depreciated,[7] as would happen if monetary policy were less restrictive, to the more appropriate level of ¥200, the dollar price of the Toyota would be $8000. This is a price difference of $1500! Given the present U.S. Buy American attitude, this may be a larger price change than would be necessary to shift a significant portion of the U.S. auto demand from foreign to domestic producers. Even if the U.S. dollar ended up depreciating only to the $1 = ¥210 level, the American dollar selling price of the Toyota would still increase by $1115 to $7619.

This too is a significant price change! Indeed, even if these estimates are excessive and the dollar depreciates only to ¥220, the cost of the Corolla would increase over time from $6500 to $7273--an increase in the price of $773.

Table I: Effect of Alternative Dollar/Yen Exchange Rates on the Cost of a Japanese Toyota Corolla

Rate of Exchange	Cost of Corolla in Yen	Cost of Corolla in Dollars
$1 = ¥246	¥1,600,000	$6,504
$1 = ¥220	¥1,600,000	$7,273
$1 = ¥210	¥1,600,000	$7,619
$1 = ¥200	¥1,600,000	$8,000

The above example illustrates that a more realistic exchange rate between the U.S. dollar and Japanese yen could remove all or most of the current U.S. price advantage of Japanese autos. There are, of course, lags before this occurs and hence it would occur only over months and years. Moreover, the Japanese are highly competitive and would try to further increase their productivity and to shave costs and profits margins to the extent possible. It would not be possible, however, for them to neutralize the bulk of the price change. This seems especially true when we incorporate the increasing attention being focused on buying American products.

Protection of the U.S. auto industry from foreign competition is neither needed nor justified. Arguments for import tariffs, quotas, domestic subsidies, or continuance of the current Japanese voluntary auto exports restraint agreement are short-sighted and detrimental to the long run viability of the U.S. auto industry. What needs to be done is to implement appropriate Federal budget policy and ease monetary policy to permit the dollar to depreciate to a more realistic level

relative to the yen. Even if the dollar does not depreciate sufficiently to eliminate all the current price advantage, the gain through this policy will, assuming American producers keep pushing improved auto quality and keep downward pressure on their prices, enhance the competitive position of the U.S. auto industry. Combining the exchange rate and higher-quality effects with an improving American economy and pent up auto demand implies the U.S. auto industry will have adequate price advantage to compete presently and to strengthen measures that enhance its long run competitive position.[8]

FOOTNOTES

[1]With (a) the overall U.S. unemployment rate at 9 percent, and closer to 11 percent when we adjust for the discouraged workers who are not counted in this figure and those working part time but desiring to work full time, (b) the pockets of high unemployment in certain areas--with unemployment rates approaching 20 percent, (c) the high unemployment rates for certain categories of workers, and (d) that the basic rate of inflation is down significantly from the 1979-80 level, it is difficult to justify a monetary policy that keeps interest rates as high as they are currently.

[2]A substantial easing of monetary policy will necessitate, for several reasons, a substantial reduction in the massive projected Congressional Budget Office deficits for FY1983-FY1985.

[3]While these relationships are well recognized by scholars of the subject, disagreement exists about some points of the analysis and/or present needs. These include questions about (a) the effectiveness of monetary policy in affecting the economy via high interest rates, (b) the relationship between monetary and fiscal policy--will a massive projected budget deficit so tighten credit conditions as to keep interest rates at an unacceptably high level and, if so, how strong is the relationship, and (c) the length and variability of the lag between interest rate changes and the effect of such on demand and production.

[4]For further explanation with qualifications, see Harold R. Williams, "Exchange Rate Determination Under Competitive Conditions," Mimeograph Paper No. 13, Department of Economics & International Business, Kent State University, 1978.

[5]Note that, contrary to popular opinion, a "stronger" dollar is not necessarily desirable.

[6]Given that the 1981 U.S. trade deficit with Japan was $18 billion and the 1982 deficit is projected to be substantially larger, the ¥190 - ¥210 range appears reasonable. Note that the exchange rate was approximately $1 = ¥200 in December 1980 and January 1981.

[7]The magnitude of depreciation depends on the degree of U.S. monetary easing relative to that of other nations and to some other fundamental factors--relative inflation, changes in real GNP, commercial policy changes, expectations, etc.

[8]A word of caution is in order. The cost of foreign products relative to comparable American products, while important, is not the basic cause of the U.S. auto industry's plight today. More important is the recession and lagging growth of the American economy. Other crucial factors are the perceived lower quality of American cars (including the poor frequency of repair record) and failure of top management to provide the auto consumer with cars that meet their desires.

*The writer is Professor of Economics and International Business and Director of the International Business Program at Kent State Univerisity, Kent, Ohio 44242.

Representative REUSS. Gentlemen, we are most grateful to you for your patience and the depth of your presentations. I'm sorry you—we—won't be at the summit, but with many thanks, and I hope that we will meet again soon, we stand in recess until tomorrow.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene tomorrow at 10 a.m., Wednesday, June 26, 1982.]

99-735 O - 82 - 6

VERSAILLES SUMMIT AND THE WORLD ECONOMY: HIGH INTEREST RATES AND PROTECTIONISM

WEDNESDAY, MAY 26, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:25 a.m., in room 2318, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Kent H. Hughes, Sandy Masur, and Marian Malashevich, professional staff members.

Representative REUSS. Good morning.

The committee will be in order.

I apologize for the early-morning ringing of bells which caused me to be late.

As a measure of my apology, I ask unanimous consent that my written opening statement be considered as read and placed in the record at this point, thus enabling us to get right to the substance of the proceeding.

[The written opening statement of Representative Reuss follows:]

Written Opening Statement of Representative Reuss

Yesterday, the Joint Economic Committee focused on the international implications of the Reagan Administration's domestic economic policies. The reports we received from long-standing international experts made for unpleasant reading. The combination of expansive fiscal policy and an overly tight monetary policy have led to a recession at home and abroad. The high U.S. interest rates that have flowed from the Reagan policy mix, have limited the ability of the European countries to stimulate their own economies and added considerably to the international debt burden of the developing countries.

Our experts yesterday were unanimous in urging a shift in the policy mix that would reduce the size of the Federal deficits in future years and somewhat loosen the reins on the domestic money supply. If the Reagan Administration fails to change direction, the outlook is for a short, weak recovery that will soon slip back into recession and for continuing turmoil in the international economy.

Today, the Committee will shift its focus to the international trading system. Again, the Reagan policies appear to be at the heart of many of our problems. Our first panel of economic specialists and former policymakers pointed to high interest rates as the key cause of the overvalued dollar. The overvalued dollar was in turn blamed for much of the recession in the United States and greater trade tensions in our domestic market. Based on yesterday's

testimony, the high interest rates have also encouraged the adoption of capital controls. We are faced with an avowedly free trade and free flow of capital administration whose policies are undermining the international economic order. We will look more closely at the question of an overvalued dollar in today's testimony.

According to the Administration, the United States will press for more open markets in the trade of high technology goods. The general feeling has been that the United States holds a strong comparative advantage in a wide range of high technology goods and is suffering from the industrial policies and closed markets of our major trading partners. However, the Administration's policies have made open trade more difficult and may in fact be undermining our relative strength in high technology goods. The Reagan budget promises cuts in basic research, infrastructure, and technical education. The Reagan recession has deterred even Silicon Valley from investing in the latest process technology. Research projects are deferred, and suddenly the short-term outlook for technical specialists has become somewhat clouded.

Today's witnesses will discuss the pressures facing the international trading system and provide fresh insights into how these pressures can be met without resorting to destructive protectionist policies.

The witnesses are:

LARRY FOX, Vice President/International Economic Affairs, National Association of Manufacturers;

WILLIAM H. BRANSON, Princeton University;

FRED BERGSTEN, International Institute of Economics; and

HAL MALMGREN, President, Malmgren Company, Inc.

Representative REUSS. We welcome Messrs. Bergsten, Malmgren, Fox, and Branson.

Thank you for submitting the very comprehensive prepared statements, which under the rule, and without objection, will be received in full and printed in the hearing record.

I will now ask you to proceed, starting with our old friend, Mr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C., AND FORMER ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL ECONOMIC AFFAIRS

Mr. BERGSTEN. Thank you very much, Mr. Chairman. It's a great pleasure to be here to talk about what's coming up or not coming up at Versailles.

I will speak more, I think, about what should happen, rather than what will happen, on the view that sessions like this ought to be pushing the leaders of the world to move in proper directions, rather than sort of complacently accepting minimal outcomes that many people predict. So, mine will be more normative than positive, although I also have a healthy degree of skepticism about how much of it will actually emerge.

VERSAILLES AGENDA

Four interrelated issues, in my view, should dominate the agenda at Versailles:

First, the stagnation of the world economy, with unemployment at or near postdepression records in every participating country and totaling about 30 million in the OECD as a whole.

Second, and of course closely related, the continued stratospheric level of real interest rates, ranging between 3 and 8 percent in the participating countries, which, in my judgment, precludes any prospect for substantial and sustained economic recovery.

Third, the massive misalinement of exchange rates among the participating countries, stemming in large part from the differences in interest rates among them, which severely exacerbates both the economic difficulties and the protectionist pressures and sets the stage for an early renewal of major international monetary instability.

And fourth, the growing threat of protectionist trade policies throughout the world, with particular focus on Japan in both the United States and in Europe, which if mishandled could produce an accelerating erosion of the open world economy which has been central to postwar prosperity.

It seems to me that the specific targets of most attention will be U.S. interest rates—and thus U.S. fiscal policy as well—and Japanese trade policies.

President Reagan and Prime Minister Suzuki will be most on the spot at Versailles. At last year's summit in Ottawa, the newness of these two leaders and several of the other participants and the newness of their programs muted much of the criticism already felt in other countries. But it seems to me much narrower escape hatches will exist at Versailles.

By contrast, other issues that have been the focus of previous summits, notably inflation and energy, will probably be discussed less extensively because of successes—for at least a moment—in dealing with them.

One other perennial topic, North-South relations, will also be treated lightly, mainly because no one has much to offer on that front—although the United States will probably come in for substantial criticism for seeking to reduce the roles of the International Monetary Fund and World Bank at just the time when they should, and could, be doing much more to help deal with global economic problems.

Finally, two issues which have not been featured heavily in previous summits, East-West economic relations and perhaps international investment, may receive a good deal of attention.

PRE-EMINENCE OF TRADE ISSUES

In terms of the major issues, the U.S. administration appears to place trade issues at the top of its agenda for Versailles. And they'll probably push for a strong declaration of support for a decision at the GATT Ministerial Meeting next November to launch a process which will eventually develop into the major multilateral trade negotiation for the 1980's. Such a negotiation, which would parallel the Kennedy round of the 1960's and the Toyko round of the 1970's, would:

Seek to develop rules to deal with the new trade problems of the 1980's.

Clean up some of the carryover trade issues from the 1970's.

And, most importantly, regain the momentum for the forces of trade liberalization as an essential element of the battle against protectionism.

This major U.S. priority, or launching a new trade effort, is well taken and deserves strong support—particularly in the face of skepticism, or even outright opposition, in some other countries.

A major new negotiation is a necessary component of any overall program to preserve, and hopefully expand, the open trading system which has been so vital for both the United States and the world as a whole.

I think such an initiative in the trade area is especially critical because of the crisis in trade relations between the United States and Japan. Japan's external surpluses are again rising rapidly. Its bilateral positions with both the United States and Europe have already soared to record levels and will soar much higher, probably into the $20 to $25 billion range, vis-a-vis the United States, within the next year.

Urgent steps are thus needed to head off the very strong possibility of worldwide restrictive actions against Japan, which would have major consequences for both the world economic system and overall relations with that critical country.

CONTRADICTION IN U.S. POLICY

However, a fundamental contradiction within U.S. international economic policy has severely hampered the ability of the United States to promote effective solutions to the trade problem, in general, and to the Japanese problem in particular. The contradiction is the administration's apparent unwillingness to take steps to eliminate

the currently massive misalinement of exchange rates—its failure to deal with the monetary underpinnings of trade—which is the single largest factor in weakening the U.S. trade position and producing record imbalances in United States-Japanese trade.

A similar contradiction existed with U.S. policy in the late 1960's, which you remember very well, Mr. Chairman, because you pushed actively to resolve that dilemma. At that time, the U.S. rejected changes in a badly misaligned exchange-rate situation late in the Bretton Woods period, but nevertheless pressed ahead for trade liberalization.

And unless you have underlying monetary equilibrium, you cannot very effectively push for trade liberalization or even resist protection.

MISALINEMENT OF EXCHANGE RATES

I would therefore suggest that it is essential at Versailles to deal with one of the essential causes of both global recession and the massive trade problem with Japan, the huge overvaluation of the dollar and undervaluation of the yen in the exchange markets.

From late 1978 through just last month, the dollar rose by 25 to 30 percent against a trade-weighted average of the other major currencies and by 40 percent against the yen. During that period, however, U.S. inflation was no better, on average, than that of the major countries and, in fact, ran about 20 percentage points higher than that in Japan.

Thus, there has been an enormous deterioration in the international price competitiveness of the U.S. economy over the past 3 years, ranging as high as 50 percent against Japan, with the following four major consequences:

First, a sharp decline in the U.S. economy due to the fall in our trade balance, which was important in pushing the U.S. economy into recession as the housing slump or the decline in the auto industry. By the time the damage is fully done, the United States will probably be losing $50 to $75 billion a year and 1 to 2 million jobs annually from the deterioration in our trade balance due to the overvalued dollar.

Second, the exchange rate misalinement has exported severe recessionary pressures to other countries. Most of the Europeans' economic problems are, of course, homegrown, but they have been exacerbated by the requirement that European nations raise their own interest rates sharply to keep their currencies from weakening to an unacceptable degree, in light of the exchange rate and interest rate situation emanating from the United States that has depressed their economies further and by a substantial amount. Developing countries, of course, are forced to pay billions more in their international borrowings and have thus had to slash their growth rates and development programs as well because of a tighter foreign exchange constraint.

A third effect of the exchange rate is substantial acceleration of protectionist pressures in the United States because of the across-the-board competitive decline of both our export and import-competing industries. A study of the postwar history clearly reveals that an overvalued dollar is the most accurate "leading indicator" of protectionist pressures on U.S. trade policy, even more than unemployment. But the current juxtaposition of dollar overvaluation and record unemployment is the most unhappy possible environment for maintaining an open-trading system.

Finally, the exchange rate problem dramatically intensifies economic conflict between the United States and Japan. We are now experiencing the third episode of major United States-Japan trade conflict in the past 12 years. Other issues, like Japan's import barriers, like the lag in U.S. productivity growth, indicate that a number of underlying structural factors are obviously important. But the only factor that explains these periodic outbreaks of tension in United States-Japan trade relations is the recurring misalinement of the dollar-yen exchange rate and is therefore crucial to solving for that reason, too.

I would quickly add, having posed the central importance of the exchange rate problem, that the administration now does seem to be recognizing the critical importance of the issue. Top trade officials of the administration have noted on several recent occasions that, to use their words, "the overvalued dollar" is the major source of erosion of the U.S. external accounts.

Secretary of the Treasury Don Regan has publicly welcomed the recent decline of the dollar in the exchange markets, predicted that it will move lower in the future, and welcomed that prospect, and noted that a weaker dollar will bolster the U.S. competitive position.

These are significant and welcome changes in rhetoric, and hopefully policy, from an administration which, until recently, seemed to take great pride in the overvalued dollar and/or professed not to know whether, in fact, it was overvalued or not.

PROPOSED POLICY MEASURES TOWARD EQUILIBRIUM

The next step, of course, is to take policy measures which would move the dollar promptly toward equilibrium levels, probably in the range 180 to 200 yen to the dollar and about two deutsche marks to the dollar. The key, of course, to get U.S. interest rates down, which, in turn, requires getting future U.S. budget deficits down sharply on a sustained basis.

My judgment, Mr. Chairman, is that the outcome at Versailles will be measured largely by the extent to which it contributes to this critical objective. It is probably much too much to expect any explicit "deal" of this type coming from Versailles if the past 2 months of domestic bargaining have not yet produced such an outcome.

An effective presentation by the rest of the world of the severe global impact of the current U.S. policy mix, however, coupled with the administration's recent recognition of the existence of the problem and its costs for the United States itself, could add to the prospects for resolving this most serious problem facing the world economy, and thus the summitteers at Versailles.

Other countries, notably Japan, also have to make major contributions for dealing with these central issues. Japan is quite understandably and properly seeking to reduce its own budget deficits. But its plans for doing so immediately would have two very negative effects:

It would further slow the Japanese economy, thus increasing its internal surpluses and maintaining downward pressure on the yen by forcing Japanese interest rates to remain low to offset the macroeconomic effects of the fiscal tightening. Japan thus needs to postpone its fiscal tightening and, in fact, stimulate its economy, while perhaps

tightening up a bit on monetary policy via a budget policy considerably more expansive than it has been planning.

Moreover—and this is a new proposal—in view of the urgency of resolving the yen-dollar problem and the difficulty of achieving prompt changes in both the American and Japanese policy mixes, I believe Japan should also move directly to strengthen its currency by declaring a temporary moratorium on all capital outflows by Japanese residents from Japan and by aggressively promoting capital inflows to Japan, mainly through foreign borrowing by the Japanese Government, much as it did successfully in 1979–80 to finance its large current account deficits.

The United States and European countries should welcome such steps by Japan, a moratorium on capital outflow and aggressive borrowings abroad. And once a clear upward trend for the yen is established—which it could be, in my judgment, by changes in the capital account—then intervene jointly in the exchange markets to accelerate the pace and extent of yen appreciation.

One final lesson which emerges from the current exchange rate misalinement is that the time has come to resume serious international discussions on improving the functioning of the international monetary system. The repeated overshooting of exchange rates to levels far from their equilibrium paths seems to be growing in both magnitude and impact. There is thus an urgent need to work out techniques to identify clearly incorrect exchange rates, such as the dollar undervaluation of late 1978 and the dollar overvaluation of the last 12 months, so that prompt and internationally concerted action can be taken, probably to keep rates within internationally agreed target zones. The Versailles summit should launch such an international effort.

Now, having addressed those major questions, I would simply sum up by saying a deal of this type, which I summarize in my written text, would be of major benefit to both the United States and the world economy as a whole dealing with the policy mixes, launching major new trade negotiation, launching serious discussions of international monetary reform, and taking immediate steps to deal with the urgent problem of the dollar-yen imbalance would mark the Versailles summit as a clear and major success—indeed, perhaps the most successful of these sessions to date. It would take advantage of the ability of these summits to make tradeoff across these areas, with both the United States and Japan giving on macroeconomic and international monetary matters and the Europeans giving mainly on trade, including East-West trade.

I would be the first to say that though a deal of this type would be enormously desirable, one cannot be very sanguine that it will occur, at least full blown, at Versailles.

OTHER VERSAILLES ISSUES

And it is thus worth noting, in conclusion, three other issues of lesser, but quite significant, importance which still could be addressed and perhaps resolved or progress made on it at Versailles.

One such issue, on which I won't elaborate, is East-West trade, where there is great need for a more unified Western position for both security and economic reasons.

A second relates to international investment, where Secretary of the Treasury Regan at London, 3 weeks ago, took a major initiative, proposing movement toward new international rules and institutional arrangements to protect international investment from increased Government incursion and manipulation. International investment, in terms of its offshore production, now amounts to about $2 trillion a year, roughly the same as international trade. But unlike trade, monetary affairs, and other issue areas, there are no international rules of the game in institutions to protect that area. Again, Versailles could launch such an initiative.

And finally, the international financial institutions, primarily the IMF and World Bank, should and probably will be discussed at Versailles. The administration here still seems to be intent on reducing the scope of operations of those institutions despite several compelling reasons to the contrary. The depressed state of the world economy, in fact, calls for more development help of the type provided by the World Bank and more stabilization help of the type provided by the Fund.

In the recycling area, private banks and other commercial lenders are backing away from the international financing of LCD deficits. So, the situation calls for increased reliance on the Fund and Bank. And the administration's own assessment of the World Bank, in fact, suggests——

Representative REUSS. I'm going to have to absent myself, Mr. Bergsten, for a couple of minutes. I will be back.

And would you just proceed, because your remarks will be noted.

And, Mr. Malmgren, would you then start in.

Mr. BERGSTEN. I'm in my last 30 seconds, Mr. Chairman.

Representative REUSS. Please proceed.

Mr. BERGSTEN. The conclusion was simply to say, on those three other issues, perhaps progress could be made, even if on the major deal that is needed it is impossible to proceed as much as the country should at Versailles.

Thank you.

[The prepared statement of Mr. Bergsten follows:]

Prepared Statement of C. Fred Bergsten

The Issues

Four interrelated issues should, and probably will, dominate the agenda at the eighth economic summit of the industrialized democracies at Versailles on June 4-6:

-- the stagnation of the world economy, with unemployment at or near post-depression records in every participating country and totaling about 30 million in the OECD area as a whole.

-- the continued stratospheric level of real interest rates, ranging between 3-8 percent in the participating countries, which precludes any prospect for substantial economic recovery.

-- the massive misalignment of exchange rates among the participating countries, stemming in large part from the differences in interest rates among them, which severely exacerbates both the economic difficulties and the protectionist pressures and sets the stage for an early renewal of major international monetary instability.

-- the growing threat of protectionist trade policies throughout the world, with particular focus on Japan in both the United States and Europe, which if mishandled could produce an

accelerating erosion of the open world economy which has been central to postwar prosperity (and harmonious international relations).

The specific targets of most attention will be U.S. interest rates (and thus fiscal policy as well) and Japanese trade policies. President Reagan and Prime Minister Suzuki will be most on the spot at Versailles. At last year's summit in Ottawa, the newness of these (and two of the other) leaders and their programs muted much of the criticism already felt in other countries -- but much narrower escape hatches will exist at Versailles.

By contrast, other issues which have been the focus of previous summits -- notably inflation and energy -- will be discussed less extensively, because of the successes (for at least the moment) in dealing with them. One other perennial topic, North-South relations, will also be treated lightly because no one has much to offer on that front -- although the United States will probably come in for substantial criticism for seeking to reduce the roles of the International Monetary Fund and World Bank at just the time when they should, and could, be doing much more to help deal with global economic problems. Finally, two issues which have not featured heavily in previous summits -- East-West economic relations and international investment -- may receive a good deal of attention.

Responding to the Major Issues

The U.S. Administration appears to place trade issues at the top of its agenda for Versailles. It will probably push for a

strong declaration of support for a decision at the GATT Ministerial meeting in November to launch a process which will eventually develop into the major multilateral trade negotiation for the 1980's. The purpose of such a negotiation, which would be the equivalent of the Kennedy Round in the 1960's and the Tokyo Round in the 1970's, would be threefold:

-- to develop rules to deal with the new trade problems of the 1980's: trade in services, trade-related investment issues and trade in high technology.

-- to clean up the carryover trade issues from the 1970's such as safeguards, subsidies and agriculture.

-- to regain the momentum for the forces of trade liberalization, as an essential element of the battle against protectionism.

This major U.S. priority is well-taken, and deserves strong support -- particularly in the face of skepticism, or even outright opposition, in some other countries. A major new negotiation is a necessary component of any overall program to preserve, and hopefully expand, the open trading system which has been so vital for both the United States and the world as a whole.

Such an initiative is especially critical because of the crisis in trade relations between Japan and the United States (and Europe). Japan's external surpluses are again rising rapidly. Its bilateral positions with both the United States and Europe have already soared to record levels -- and will soar still higher, probably to $20-25 billion vis-a-vis the United States -- within the next eighteen months. Urgent steps are needed to head off the

very strong possibility of worldwide restrictive actions against Japan, which would have major consequences for both the world economic system and overall relationships with that critical country.

A fundamental contradiction within U.S. international economic policy, however, has severely hampered its ability to promote effective solutions to the trade problem in general and the Japanese problem in particular. This contradiction is the Administration's apparent unwillingness to take steps to eliminate the currently massive misalignment of exchange rates, the single largest factor in weakening the U.S. trade position and producing record imbalances in U.S.-Japan trade, while simultaneously opposing trade restrictions and proposing new liberalization. A similar contradiction within U.S. policy in the late 1960's was instrumental in fostering the collapse of the Bretton Woods system of fixed exchange rates, when the United States also rejected changes in a badly misaligned exchange-rate constellation but continued to press for ever freer trade.

It is essential at Versailles to deal with one of the central causes of both global recession and the massive trade problem with Japan: the huge overvaluation of the dollar and undervaluation of the yen in the exchange market. From late 1978 through last month, the dollar rose by 25-30 percent against a trade-weighted average of the other major currencies and by 40 percent against the yen. During that period, U.S. inflation averaged about the same as other countries' and ran about 20 percentage

points higher than in Japan. Thus there has been an enormous deteterioration in the international price competitiveness of the U.S. economy over the past three years, ranging as high as 50 percent against Japan, with four major consequences:

-- a sharp decline in the U.S. economy due to the fall in our trade balance, which was as important in pushing the U.S. economy into recession as the slumps in the housing or auto industries. The trade balance declined despite the domestic recession and steep fall in oil imports, which should have produced a sharp improvement instead; the recession in 1975, for example boosted the U.S. trade balance by $20 billion. By the time the damage is fully done, the U.S. will be losing $50-75 billion and 1-2 million jobs annually from the deterioration in our trade balance.[1/]

-- the export of severe recessionary pressures to other countries: most European nations have had to raise interest rates sharply to keep their currencies from weakening to an unacceptable degree, depressing their economies substantially (and by much more than they gained from the enhanced trade competitiveness fostered by their lower exchange rates); developing countries were forced to pay billions more on their international borrowings, and thus had to slash their development programs because of a tighter foreign exchange constraint, and also lost competitiveness directly if their currencies were tied to (and thus dragged up by) the dollar.

-- substantial acceleration of protectionist pressures in the United States, because of the across-the-board competitive decline

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1/ See my "The Villain is the Overvalued Dollar", Challenge, March/April, 1982.

of both our exporting and import-competing industries. The postwar history clearly reveals that an overvalued dollar is the most accurate "leading indicator" of protectionist pressures on U.S. trade policy, and that the current juxtaposition of dollar overvaluation and record unemployment is the most negative possible environment for maintaining an open trading system.

-- dramatic intensification of economic conflict between the United States and Japan. We are now experiencing the third episode of major U.S.-Japan trade conflict in the past twelve years, whose periodic outbreaks can only be explained by the recurring misalignments of the dollar-yen exchange rate.[2/]

The Administration now does seem to be recognizing the critical importance of the exchange-rate issue. Top trade officials have noted on several recent occasions that 'the overvalued dollar" is the major source of erosion of the U.S. external accounts. Secretary of the Treasury Regan has publicly welcomed the recent decline of the dollar in the exchange markets, predicted that it will move lower in the future and welcomed that prospect, and noted that a weaker dollar will bolster the U.S. competitive position. These are significant and welcome changes in rhetoric, and hopefully policy, from an Administration which until recently seemed to take great pride in the overvalued dollar and/or professed not to know whether it was in fact overvalued or not.

[2/] For a comprehensive analysis see my "What To Do About Japan", a speech presented to the Japan Society on May 5. The proposals summarized below regarding the Japanese situation are elaborated in that presentation.

The next step, of course, is to take policy steps which would move the dollar promptly toward equilibrium levels, probably in the range of 180-200 yen and about 2 DM to the dollar. The key is to get U.S. interest rates down, which in turn requires getting future U.S. budget deficits down sharply on a sustained basis.

The outcome at Versailles will be measured largely by the extent to which it contributes to this critical objective. It is probably too much to expect any explicit "deal", if the past two months of domestic bargaining has not yet produced such an outcome. An effective presentation by other countries of the severe global impact of the current U.S. policy mix, however, coupled with the Administration's recent recognition of the existence of the problem and its costs for the United States itself, could add to the prospects for resolving the most serious problems facing the world economy (and thus the summiteers at Versailles).

Other countries, notably Japan, also need to make major contributions to dealing with these central issues. Japan is quite understandably and properly seeking to reduce its own budget deficits. Its plans for doing so immediately, however, would have two very negative effects: further slowing of the Japanese economy, thus <u>increasing</u> its external surpluses, and maintaining downward pressure on the yen by forcing Japanese interest rates to remain low in order to offset the macroeconomic effects of the fiscal tightening. Japan thus needs to postpone its fiscal tightening, and in fact stimulate its economy -- while

perhaps tightening up a bit on monetary policy -- via a budget policy considerably more expansive than it has been planning.

Moreover, in view of the urgency of resolving the yen-dollar problem and the difficulty of achieving prompt changes in both the American and Japanese policy mixes, Japan should also move directly to strengthen its currency by declaring a temporary moratorium on all capital outflows by Japanese residents and aggressively promoting capital inflows to Japan, mainly through foreign borrowing by the Government of Japan, as it did in 1979-80. The United States and European countries should welcome such steps (despite their divergence from the ideological preferences of the Administration here, and the long-term desirability of liberalizing Japan's capital markets) and, once a clear upward trend for the yen is established, intervene in the exchange markets jointly with Japan to accelerate the pace and extent of yen appreciation.

The final lesson which emerges from the current exchange-rate misalignment, with its particularly severe impact on U.S.-Japan economic relations but with major adverse effects on the global economic positions of the United States and the Europeans as well, is that the time has come to resume serious international discussions on improving the functioning of the international monetary system. The repeated overshooting of exchange rates, to levels far from their equilibrium paths, seems to be growing in both magnitude and impact.

There is thus an urgent need to work out techniques to identify clearly incorrect exchange rates, such as the dollar undervaluation of late 1978 and the dollar overvaluation of the last twelve months, so that prompt -- and internationally concerted -- action can be taken, probably to keep rates within internationally agreed "target zones". The Versailles Summit should launch such an effort.

The U.S. Position at Versailles

At Versailles, the United States should thus initiate or accept several proposals to deal with the core problems of the contemporary world economy:

-- renewed efforts to tighten its future fiscal policy substantially in order to help bring down U.S. interest rates, both stimulating the world economy directly and contributing mightily to the needed realignment of exchange rates.

-- deferral of any tightening of Japan's fiscal policy, to stimulate its economy and strengthen the yen via higher Japanese interest rates.

-- explicit approval of renewed Japanese efforts to attack the trade problems at its core, by strengthening the yen via direct manipulation of its capital account.

-- joint intervention in the exchange markets, with the Europeans and Japan, to assure and hasten a restoration of currency equilibrium as quickly as possible.

-- agreement, to be reached at the GATT Ministerial in November, to start a process leading to inauguration of new multilateral negotiations to deal with the major trade problems of the 1980's.

(This would be a major "concession" sought from the Europeans as part of the overall package.)

-- initiation of new talks aimed at finding ways to check the growing tendency of the international monetary system to produce severely misaligned exchange rates for protracted periods of time.

Such a "deal" would be of major benefit to both the United States and the world economy as a whole. It would mark the Versailles summit as a clear and major success, rivaling or even surpassing the Bonn summit of 1978 and the Tokyo summit of 1979, the most successful of these sessions to date. It would take advantage of the ability of summits to make tradeoffs across issue-areas, with both the United States and Japan "giving" on macroeconomic and international monetary matters and the Europeans "giving" mainly on trade (including East-West trade, see below). For both President Reagan and Prime Minister Suzuki, it would snatch victory from the jaws of defeat -- or at least from major continuing pressures, and even hostility, which would increasingly pervade the security as well as economic relations of the two countries if the problem were permitted to fester with their positions continuing to be viewed as obstructionist barricades to resolution thereof.

Other Issues

Desirable though it would be to achieve a major "deal" of the type just addressed, one cannot be very sanguine that it will occur -- at least full blown at Versailles. It is thus worth noting that there are several issues which are of lesser importance, but still quite significant, which could be addressed -- just as

earlier summits contributed to progress on such matters, including funding and initiatives for such key international institutions as the International Monetary Fund and World Bank.

One such issue, on which the Administration will presumably make a major push, is East-West trade. A more unified Western position on this matter would be most welcome, for both security and economic reasons. There is some prospect for success for a U.S. effort to tighten the COCOM rules and their implementation, and to limit government credits and financial guarantees for trade with the Soviet Union. Indeed, including this issue in the priority category outlined above would provide for a greater European contribution to the overall "deal".

A second issue relates to international investment. Offshore production by multinational firms now approximates $2 trillion annually, about the level of international trade. Unlike trade or international finance or many lesser issues, however, international investment has no international rules or institutional arrangements to protect it from excessive governmental intervention and beggar-my-neighbor policies. In fact, just such policies are being adopted by many host governments in increasingly blatant efforts to tilt the advantages of international investment -- production, jobs, exports, technology, etc. -- in their direction via incentives to lure the investment to their shores in the first place, performance requirements (such as local content rules and minimum export quotas) to dictate the economic effect of the investment once it is in place, and deviations from national treatment (to discriminate against

the foreign-based firm after it has entered the host country).

The rapid spread and intensified impact of these measures is leading toward a potentially explosive backlash in the home countries where these multinationals are based, most notably in the United States. The alternative to such an onset of "investment wars", which could have a disastrous effect on international investment and thus damage the world economy further, is the creation of new international arrangements which would limit -- and, perhaps, eventually eliminate -- the distorting actions of the many host countries which now employ them.[3/] Secretary Regan took a major initiative in this direction earlier this month,[4/] and similar proposals at Versailles could lead to the start of a major institution-building process to safeguard this vital component of international economic relationships.

A third issue, this time with the United States on the defensive, relates to the international financial institutions -- primarily the IMF and IBRD. The Administration still seems to be intent on reducing the scope of operations of these institutions, despite several compelling reasons to the contrary:

-- the depressed state of the world economy calls for more,

[3/] The initial call for such arrangements is in my "Coming Investment Wars?" in Foreign Affairs, October 1974, and was elaborated in C. Fred Bergsten, Thomas O. Horst, and Theodore H. Moran, American Multinational and American Interests (Washington: The Brookings Institution, 1978).

[4/] See his remarks before the American Chamber of Commerce in London, May 7, 1982.

not less, development help of the type provided by the World Bank and more, not less, stabilization help of the type provided by the Fund.

-- despite the probable disappearance this year of the OPEC surplus, the external deficit of the developing countries will remain huge -- on the order of $70-80 billion. Moreover, private banks and other commercial lenders are scaling back their willingness to finance these deficits for a variety of prudential reasons. Hence, the global payments situation calls for increased reliance on the Fund and Bank rather than the reverse.

-- the Administration's own "assessment" of the World Bank (and the regional development banks) rejects virtually all of the important criticisms leveled at them in recent years, yet inexplicably calls for a cutback in U.S. support. Moreover, the "assessment" calls for major U.S. efforts to win adoption of important changes in the policies of the banks but candidly admits that U.S. leverage to achieve such changes will be severely circumscribed if U.S. financial support is not forthcoming.

Most of the other countries at Versailles can be expected to push the United States to resume its traditional, bipartisan support for the IMF and the multilateral development banks. On this one, the Administration should give in as gracefully as possible -- in the interest of both the U.S. economy and U.S. foreign policy.

Conclusion

Economic summits should never be judged solely by their

ability to produce concrete results. On some occasions, the international situation and domestic politics in the key countries permit such results. On other occasions, the main effect is on subsequent decisions taken individually by the national leaders, sensitized much more fully by the summit process to the concerns of their major allies and trading partners.

Even at this late date, it is difficult to predict which -- if either -- of these outcomes will emerge from Versailles. The world economic (and security) situation clearly cries out for important changes in policy, particularly in the United States and Japan. On the other hand, the key issues have already been subjected to extensive debate within the key countries (and internationally) with only modest signs that the needed alterations will occur.

The juxtaposition of the Versailles summit on economic problems with the immediately subsequent NATO summit in Bonn, however, raises at least a modest prospect for progress. The current economic malaise of the NATO countries clearly has an erosive effect on their security relationships, both directly by making it more difficult to finance increased military preparedness and indirectly by weakening the social and political cohesion of the major members. The Administration quite rightly recognizes the urgent need to bolster NATO, and the confluence of Versailles and Bonn should help persuade it to make changes in economic policy which would substantially promote such an outcome.

Whatever the outlook, at or subsequent to Versailles and Bonn, progress is badly needed. The world economy is "dead in the water", to again quote Secretary Regan. Protectionist trade pressures are mounting. Severe monetary misalignments remain. The need for action is clear. Let us hope that the leaders at Versailles both recognize that need, and move decisively -- and cooperatively -- to meet it.

Representative REUSS. Mr. Malmgren.

STATEMENT OF HAROLD B. MALMGREN, PRESIDENT, MALMGREN CO., INC., WASHINGTON, D.C., AND FORMER DEPUTY SPECIAL TRADE REPRESENTATIVE

Mr. MALMGREN. I will summarize my prepared statement, but you have it for the record.

In this statement, I try to give a "mountain top" perspective over the valley of the next 10 years: What it looks like, and what some of the leaders are thinking about, concerning that valley.

The Versailles Summit leaders next week will have good news and bad news. The good news, of course, is that inflation is down in almost all of the industrialized countries. But the bad news is that unemployment is up virtually everywhere, to levels not seen since the Great Depression, and the global recession has not reached bottom.

WORLD TRADE STAGNATION

Moreover, we are in the third year of world trade stagnation, which is unique to the postwar period. World trade grew in volume by only 1 percent in 1980, and it has been decreasing since that time. Industrial production in the Western industrialized countries, as a group, has been stagnant since 1980.

So, what we have is a fixed or stagnant world economic pie. It's not growing, and the Western industrialized nations are dead in the water. The leaders are much aware of that, and they don't want to point it out, so they will tend to deflect attention from his predicament. But underlying the predicament is something else. And that is:

Because of the domestic unemployment, economic dislocation, foreign exchange or debt problems, and other difficulties, virtually every government in the world is now trying to increase exports, limit imports, and promote domestic jobs. And with a pie that is not growing, it is self-evident that that can only be achieved by one taking from another.

In this climate, obviously political leaders are quick to blame anybody but themselves, and no one confesses that his own policy is wrong. So, we will see in the summit a certain amount of attention to what others are doing that create problems for oneself.

FAVORABLE CONDITIONS FOR PROTECTIONISM

The conditions right now are exceptionally favorable for economic nationalism, isolationism, and indiscriminate protectionism. We could easily see, if the conditions continue much longer, a world economic contraction that could be quite severe. But that is not the main preoccupation of some of the leaders.

ECONOMIC PROBLEMS PARTICULAR TO EUROPE

Beyond the current crisis, the West European leaders see a much greater problem in the years ahead. They perceive that the unemployment problem will increase during the 1980's, even if economic recovery occurs, because they believe—and I think it is correct for

Europe—that technological developments in automation and computer information systems will reduce the employment needs of industry in Europe dramatically. And they believe that competitive pressures from other countries—Japan, the United States, the NIC's, and even from Eastern Europe—will also create major problems for European industry.

So, they see a decade of trouble, not a year or two of trouble.

For them, the current recession is only the beginning of a long period of social and political problems. The West European countries look at the level of U.S. interest rates, and at the intensity of Japanese exports to Europe, in that context. And for them, they see Japan and the United States as part of the problem, not part of the solution.

JAPANESE LONG-TERM PERSPECTIVE

The Japanese leadership also takes a much longer perspective than we are accustomed to doing. They have, for many years, had a forward vision put together by industry and government, in close consultation. It can be said that industry and government in Japan today believe that there will be sweeping changes in the structure of Japanese industry and services, and of the related job requirements, in the 1980's and 1990's.

What this amounts to is that the Japanese and West European leaders approach the present world economic problems in a much longer term context than the United States does. They perceive a decade or more of major dislocation and adjustment, and they feel that government must guide that process, in order to moderate the unemployment and social costs that otherwise seem to them to be inevitable. We could say they are pessimistic, but they feel that they are being realistic.

U.S. POLICY APPROACH BIAS

It is my view, after some 20 years in and around the Washington policymaking system, that the American approach precludes that type of longer view. Instead, we are extremely short term in our orientation. Moreover, our objectives in the tasks we set internationally are usually based on recent complaints from domestic interests. As you well know, we have complaints from industry, agriculture, labor, and other groups daily—complaints about foreign barriers to our exports, complaints about international financial and investment policies, complaints about imports. And some of the people who complain advocate international negotiation, but many others want unilateral action.

As we all know, the policy process tends to respond to those complaints. The squeaking wheels get the oil.

Frankly, in my experience, the enterprises that come to Washington to seek help and complain about the practices of others are most often enterprises that failed to see what was coming, failed to see things that were foreseeable. They often come to complain about competition from Japan, that they had not recognized would be there; and yet, one can today already see what will be happening in Japanese exports 2, 3 or 4 years from now.

They are confronted by technological developments, changes in global cost relationships, exchange rate problems, differential inflation rates, and productivity performance—and many other factors. But the tendency will be to say that, "It's the policy of somebody else that does it; therefore, we need some help." And when those complaints come in, it is not so often that the Government stops to think, "Well, if we've got a lot of losers, we must have some winners, too, because we're not really that badly off, and it is rare that the winners are brought in to compare notes with the losers."

In other words, we build policy around complaints, and we rarely ask those that are succeeding what it is that we are doing right and what we might improve on.

Now, this comes up in a particular area, now. There is in Washington, I believe, a creeping paranoia about technological developments in other nations. And there is such a paranoia that there is concern about the potential leakage of our own technology to other nations—not only our foes, but our friends.

The companies that raise these concerns are often those that are having difficulty keeping up with the accelerating rate of technological change.

Now, for Washington to understand a problem takes time. It has to study the problem and has to examine everybody's views, and it has to then fight, bureaucratically, to a decision. That takes a lot of time. Usually the policy decision has been overtaken by events, sometimes by more than a year or two. Our international economic decisions, based on complaints from enterprises that failed to see what was foreseeable, even then reflect problems that arose a year or two earlier, but rarely the problems currently.

NEED FRAMEWORK FOR FORWARD THINKING

Now, that would suggest the government has to start to anticipate difficulties, but it will be immediately said by some that means you have to plan the economy. And I don't agree with that.

It seems to me, first of all, that it's self-evident that the Government must create a framework of rules and of rights and obligations, within which the economy has to function. That must include an international framework. There are problems with the present international institutions and the rules, and they have to be adapted from time to time.

There is a need to revitalize and modernize them. But to reform the system requires multilateral negotiation. It requires even more than that. It requires a domestic consensus as to what we want to do, and it requires an international consensus of what needs to be done, based on some perception of mutual advantage among nations. That process takes a long time.

The Kennedy round took 6 years, from its idea, its conception, to its conclusion. The multilateral trade negotiations finished in 1979—actually, the work on those began in 1967, and it took 12 years to put that together. In each case, no sooner have we finished the negotiations than industry and other people said, "You didn't do the right thing. Those were the problems of 10 years ago, but now we have new problems, so we really need a new set of rules."

In other words, we were really dealing with something, over time, that had long since been overtaken.

Now we are starting up a new pressure, and at the summit, the United States will press the other countries to initate some new kind of negotiation, and the others will say, "We're not ready. We don't have a consensus. You don't even have a consensus yourself. There is no American common view."

Yes, there is a problem in some of the fields that the United States wants to raise, but first we need a working program to see what the problems are in detail and what should be done. I think that that's the right approach, frankly. And so, they will endorse the idea of adapting and approving the international trade framework and avoiding protectionism. And arguing this should be an elaborate process of consensus-building and negotiating to be begun, but not to be initiated with much fanfare.

In approaching this new activity, it is my view that we are not ready yet, because we haven't looked forward as to what it is that we think should be the framework at the time when this negotiation is finished.

It's my view that it's going to take at least 8 years. In other words, we're talking about 1990 before a new international trade framework is developed. The work program in the GATT will take at least 3 years first; and then, I think at least 5 years of negotiation after that.

So, we have to think what will be the problems of 1990, not the problems of 1970. To anticipate in that way requires us to somehow mobilize the thinking of our winners as well as our losers, of our noncomplainers as well as our complainers.

I note in the papers some developments that I think provide a framework for forward thinking, that we can now foresee, that are already underway, that are going to change the framework for economic policy, and that we must deal with:

First, we're going to have the so-called information revolution coming on us very fast, with major changes in the way that we carry out industrial production and the way that we carry out jobs in the offices.

EMPLOYMENT DISLOCATION

We're going to see a massive amount of employment dislocation, because there are going to be a lot fewer people needed by 1990. In the auto industry, in my view, you will see the need for less than half of the present level to produce record-level production. In other words, to go to 10 to 12 million units a year in the United States, you will need less than half the present workers now. I'm not even counting the unemployed. Indeed, the unemployed probably will never return to work, except for a year or two.

We're going to see a major change in the percentage of our work force in industrial jobs. We now have 22 percent of our work force in industrial jobs; that will diminish sharply.

In addition to that, we're going to see some changes in the materials there, including raw materials that we so much worry about when we have these debates about, "is the United States dependent on other countries for critical materials, et cetera."

It is my view that the new materials, manmade, will have a massive dislocation effect on most of our basic metals industries. For example, fiber optics will replace copper and aluminum in all telecommunications uses. Fiber optics is only part of the problem for copper and aluminum, because there are new superconductors coming. In my view, that whole sector is in trouble.

New fine ceramics will challenge and probably replace all metals in the engines, not only engines for cars, but for trucks, aircraft, and other transportation systems. Carbon fiber and ceramics will provide the shells of autos and aircraft. Autos with no metal at all will be on the market by 1990. Carbon fiber products will challenge steel, aluminum, and many nonferrous metals used in sophisticated alloys, because of the exceptional light weight, strength, and stress resistance of carbon fiber.

FUTURE OF BASIC INDUSTRIES

All of these developments place a cloud of uncertainty over the future of many of our basic industries, including steel, nonferrous metals, and chemicals. They raise doubts about the future of basic raw materials from the ground. And we're going to have advances in biotechnology that will lengthen life expectancy and improve our health, but also will change chemical processes in manufacturing.

INTENSIFIED GLOBAL COMPETITION

We will see, in addition to all of these developments, intensified global competition. Many countries we don't think of as industrial competitors will be coming into the market. Countries like Brazil are moving up the technology ladder fast.

WILL UNITED STATES RETAIN TECHNOLOGY LEADERSHIP?

In the new climate, will the United States retain technological leadership?

I think we can do so, but the gap will narrow. For example, Japan will come very close and take the lead in certain areas. Japan is already graduating more engineers each year than the whole of the United States, with half the population. We will have to review technology policies at home, before we start negotiating technology policies with other countries.

I think that probably what this means is that we're going to have to have a rather fundamental shift in our economic policy perspective, to recognize, on the one hand, the existence of a global market place, and to recognize, on the other, the awesome challenges over the next few years in technology and from new sources of competition, challenges which we can now already foresee.

Now, the summit leaders will agree to establish some kind of exploratory consultative mechanism for macroeconomic policy, and they will agree to study exchange rate intervention. I believe that they also will take up the question of technology and its challenges in the 1980's, and say that must be looked at, too. And the United States will, somewhat reluctantly, go along.

EAST-WEST ISSUES

The United States will probably spend most of its effort not on Japan, but on East-West issues. The United States wants Europe to pull its horns in and stop doing so much business with the Soviet bloc. The Europeans simply don't agree with the American approach.

In my view, it seems to me far preferable to avoid a United States-European clash over policies toward the East, because I believe that the Soviet Union is already in deep trouble. Changes in policy won't affect the deterioration of this very much, one way or the other.

But to build a consensus in the West is something else, because the other countries are thinking much longer term about their policies than the United States. If we continue to base our international meetings like the summit on current complaints, we will simply not be able to deal with the problems ahead. No nation can run well by looking backward.

It seems to me that the function of the summiteers, at this particular juncture, is not to reach agreement so much as it is to shift the perspective of their respective nations, to get our eyes away from our feet and to look at where we're going. Otherwise, we will feel the full pains of the dislocation of the 1980's that I now foresee.

Thank you.

[The prepared statement of Mr. Malmgren follows:]

PREPARED STATEMENT OF HAROLD B. MALMGREN

The leaders who gather at the Versailles Summit next week face good news and bad news. The good news is that inflation is down. The bad news is that unemployment is up virtually everywhere -- to levels not seen since the Great Depression -- and the global recession has not yet reached bottom.

The world finds itself in the third year of stagnation of world trade. World trade grew in volume by only one percent in 1980. In 1981 it declined slightly. In 1982 the decline is continuing. Even excluding petroleum trade, the volume of world trade has been decelerating during this period, and in 1982 has begun a real decline.

Industrial production in the Western industrialized countries as a group has been stagnant since 1980.

This means that the world economic pie is not growing; and even the Western industrialized nations are dead in the water.

However, because of domestic unemployment, economic dislocation, and foreign exchange or debt problems, virtually every government in the world is trying to step up exports, slow down imports, and promote domestic jobs. With a pie that is not growing, a greater share for one nation can only be achieved by a smaller share for another.

In such a climate, political leaders are quick to blame anyone but themselves. Since foreigners don't vote, they become the easiest target. Blaming the policies of other nations, and taking action against them, has become politically popular everywhere.

The conditions are exceptionally favorable for economic nationalism, isolationism, and indiscriminate protectionism. A world economic contraction could easily occur, unless the Western leaders recognize the need for forebearance and sensitivity to their mutual predicament.

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However, beyond the current economic crisis the West European leaders see a greater problem in the years ahead: Some of the European governments have been looking forward, in consultation with industry, and what they see is politically and socially disquieting. The European leaders are being warned by their staffs that unemployment in Western Europe is likely to rise further during the next few years, because of technological developments in automation and computer-information systems, and because of intensifying competitive pressures from a widening array of foreign sources (from Japan, the U.S., the newly industrializing countries, and even from Eastern Europe). As a consequence, the European leaders and many other European officials and businessmen are worried that the current recession only marks an early phase of major social and political problems from unemployment that could persist throughout the 1980's.

The West European concerns about the level of U.S. interest rates, and about the intensity of Japanese exports to Europe, are viewed from this perspective. At the Summit, they tend to see the U.S. and Japan as part of the problem, rather than part of the solution.

In Japan, there has been for many years a forward vision taken by industry and government, periodically revised through consultation and evaluation of the consensus judgments about likely developments. The industry and the government in that country envisage sweeping changes in the structure of industry and services, and of the related job requirements, in the 1980's and 1990's.

Thus the Japanese and West European leaders approach the present world economic problems in a longer term context. In doing this, they are well aware that the U.S. Government perspective is much shorter-term.

Fundamentally, they do not share the U.S. confidence that if government plays a lesser role, economic forces will bring about the best results in the years ahead. They perceive a decade or more of major dislocations and adjustments, and they feel that governments must guide that process to moderate the unemployment and social costs that otherwise seem inevitable.

American Myopia in Foreign Economic Policy

The American approach to any international gathering on economic issues is usually very short-term in its orientation. If there are tasks to be accomplished, these are usually derived from analysis based on recent complaints from domestic

interests.

In the United States, our government is continually beseiged by complaints from domestic industry, agriculture, labor, and other groups which have encountered problems with imports, or with foreign barriers to their exports, or with international financial and investment policies of other nations. Some of these groups advocate international negotiation to resolve their problems. However, many of them want unilateral action against the foreigners, or they want special assistance to help them adjust to foreign competition.

The policy process tends to respond to serious complaints. The squeaking wheels get the oil.

But enterprises that come to government for help are often suffering from their own failure to see what was coming in the marketplace. They often come to Washington because they failed to anticipate new sources of competition from Japan or from the newly industrialized countries, or from new man-made substitutes generated by technology, and from major changes in global cost relationships due to energy shocks, differential inflation rates and productivity performance, and moving exchange rates. When the U.S. Government reacts to complaints -- whether in Congress or the Executive Branch -- there is rarely any effort to see whether there are some winners in our economy, as well as the

losers we hear from in Washington.

For example, there seems to be a creeping paranoia in Washington about technological developments in other nations, and potential leakage of our own technology to others -- whether friend or foe. The domestic voices most often heard in Washington are the representatives of companies that are in difficulty keeping up with the accelerating rate of technological change throughout the world.

Moreover, it takes time for Washington to study and understand a problem, and by the time a policy decision is reached, the problem has usually been overtaken by new circumstances. It has been my experience over the last two decades in and around the Washington policymaking system that the international economic decisions of our government most often address yesterday's problems, based on complaints from enterprises that failed to anticipate what was foreseeable. Tomorrow's problems are almost never addressed in the making of foreign economic policy.

One response to this could be that the government cannot anticipate without involving itself in planning the economy. I fundamentally disagree with that perception.

It Takes Time To Negotiate New Groundrules For World Business

Government must, as one of its functions, create and maintain a framework of rules, a framework of rights and obligations, within which the economy functions. The framework must include international rights and obligations, because the different governments would otherwise adopt conflicting policies and generate trade, investment, and other confrontations. The world economy functions as well as it does because most governments operate within a variety of multilateral and bilateral agreements and institutions that create the conditions for orderly economic relations.

These institutions and rules must be adapted from time to time. There are, for example, many voices in our nation that claim that GATT was developed at another time, for another context, and has now become obsolete. Some people even say that GATT must be done away with in favor of new rules -- perhaps unilaterally imposed by the U.S. under the principle of reciprocity. That way of thinking would lead to a global breakdown. But there is nonetheless a need to revitalize and modernize the world rules for trade and other financial and commercial activities.

To reform the system means multilateral negotiation. To negotiate, there must first be established a domestic consensus here and in a number of other nations that change is necessary. Then the negotiators must seek a new international consensus on

what needs to be done, based on mutual advantage among nations. Then they can cut a deal, in the final months of negotiating.

The process takes a long time. In the 1960's, we experienced the Kennedy Round of trade negotiations among most of the significant trading nations, which took about six years from the idea in 1961 to the final package in 1967. When we came to the end, complaints were widespread that the tariff problems solved were those of the early 1960's, whereas circumstances had changed. The new problems were said to be those of nontariff intervention by governments (e.g., subsidies, government purchasing policies, discriminatory technical standards and valuation practices). A new GATT Work Program was launched by Ministers in the autumn of 1967, and an effort began to develop an inventory of nontariff barriers and distortions to trade. In 1973, Ministers from more than 100 nations met in Tokyo to launch the so-called Tokyo Round, or Multilateral Trade Negotiations, and that negotiation continued to a conclusion in Geneva in the spring of 1979. Twelve years were necessary.

Now, we hear complaints that this last round of trade talks was fine, but really reflected the problems of the early 1970's, not the problems of today. So the U.S. Government is now pressing other nations to start up another global negotiating effort, to cover new issues like services, investment, and technology policies of governments, about which there are many

current complaints.

The Summit leaders will no doubt acknowledge that there are problems in the world trading system, and that every effort must be made to hold the line against protectionism. They will probably endorse the need for a new program of work in the GATT, to be launched in November this year, to lay the foundation for a negotiation at a later date.

The U.S. will then take the lead in starting up another multi-year consensus-building and negotiating exercise. But this process will not be completed until the end of this decade -- or even later. The results of a new negotiation will apply to world business in the 1990's.

Therefore, based on past lessons, the government should really try to anticipate what the problems will be in the 1990's, when the new framework will prevail, rather than study what the problems were in the last couple of years.

To do this, we need to ask business, labor, agricultural groups, bankers, and others to look ahead and help define what kind of problems they foresee, and what kind of framework of rules they want to prevail, in the future.

This means pulling together the thinking of our winners as

well as our losers. It means encouraging business to look beyond the next quarterly earnings report and the next few months' cash flow problems to the next five or ten years.

The Challenges Ahead That Are Already Foreseeable

There are some developments that are already under way, and that can be foreseen without a crystal ball. The pace of these developments will depend on certain constraints, such as the rate of capital spending, the rate of economic growth, the share of business earnings committed to R&D, the degree of protectionism, and other such factors. Nonetheless, the direction of change that is already set, and the inertia that will carry it for several years at least, seems to encompass the following developments:

(1) The Information Revolution

(2) The Challenge of Man-Made Materials to Traditional Natural Resources

(3) Advances in Biotechnology and Life Sciences

(4) Intensified Global Competition and Growing Interaction of National Economies.

Let me touch on each of these areas briefly.

The information revolution is based upon rapidly declining costs of computer memory and processing capabilities and of communications. There will be enormous economies of scale, on a worldwide basis, generated by progress in information technologies. We can already see that the "factory of the future" and the "office of the future" are coming into place now. Automotive production will require very few workers by the end of this decade, regardless of the level of imports. Engineers will generally instruct machines on production lines through computer-telecommunications systems, without the use of blueprints or skilled machinists. Progress in design R&D will accelerate, as computers simulate what once had to be tested in laboratories or wind tunnels.

The U.S. presently has about 3 percent of its workforce in agriculture, about 22 percent in industrial jobs, and the rest in services and in government. The share in industry will probably decrease significantly in the 1980's. But the job requirements in the expanding services sectors are information-based. They require a higher level of education, with greater technical versatility, than that for many of the jobs in today's factories.

We shall probably face a serious adjustment problem, but we

have no human resource policies that take this into account -- and we are presently gutting support for higher education without developing alternatives.

World competitiveness in the advanced industrial sectors in the late 1980's and early 1990's may not be based as much on relative labor costs as on the degree of automation of production and the technological content of products. These latter factors will be heavily dependent on the computer-telecommunications infrastructure and the capability of people to deal with information-based economic activities.

The new materials include fiber optics, which will probably totally replace copper and aluminum as communications conductors. New superconductors may knock out copper and aluminum for transportation of electricity. New fine ceramics will challenge and probably replace all metals in the engines of autos, trucks, aircraft, and other transportation systems. Ceramics, certain types of superplastics, and carbon fiber can provide the shells of autos and aircraft. Given the objectives of improving fuel efficiency, performance, and control of emissions, the introduction of autos with no metal at all is only a question of time -- somewhere between the end of this decade and the end of the next. Carbon fiber products will directly challenge steel, aluminum, and many nonferrous metals used in sophisticated alloys, because of the exceptional light

weight, strength, and stress resistance of carbon fiber.

These developments will soon place a cloud of uncertainty over the future of many of our basic industries, including producers of steel, nonferrous metals, and chemicals. They will raise doubts about the future of basic raw materials from the ground -- and therefore raise doubts about the future of those developing nations that rely on exports of primary products based on non-renewable natural resources. Of course the question of relative costs will play a determining role, but the costs of the new materials are falling fast, and their properties often exceed natural materials.

Advances in biotechnology will not only lengthen life expectancy and improve our health. There will also be applications of genetic engineering that will challenge present chemical processes in manufacturing man-made chemicals and fibers.

To add to these technological challenges, there will be many more sources of competition in the 1980's and 1990's. The inefficient petrochemical producers of Japan and Europe will be challenged by new producers in cheap oil and gas regions of the world, such as in Alberta, the Middle East, and Mexico. The consumer products which seem to come like a flood from Japan today will no doubt soon be followed by similar products from

Mexico, Singapore, Hong Kong, Taiwan, Korea, Brazil, and other countries.

Technology has already started to move ahead in newly industrialized countries like Brazil -- in areas ranging from aerospace engineering to nuclear energy. With the coming of cheap computer-telecommunications networks on a global basis, engineers and scientists in Latin America, Southeast Asia, and Africa will be able to have ongoing access to current processes of technology development and the design and engineering of industrial production facilities through global communications. Technology will spread faster and faster, and for many product areas competitiveness will involve global confrontations between large-scale, highly diversified conglomerates, with smaller, innovative enterprises finding their own niches, but able to keep them only by continuous innovation or by becoming part of larger, more diversified enterprises.

As for the vast pool of labor in the developing nations, I am no longer confident that will be enough to give those countries strength in world trade competition. We shall, for example, see complete automation of production of textiles and apparel in the next ten or fifteen years in at least some countries.

What all of this means is far-reaching change -- change in

the pattern of jobs available, in the structure of industry, in the pattern of world trade, in the relative competitiveness of key sectors. But adaptation to change requires capital spending -- and in that area the U.S. in recent years has been sluggish, at a time when it should have been increasing the rate of capital formation to cope with world economic adjustments.

Will the U.S. Retain Technological Leadership?

But in development of technology the U.S. is also facing intensified competition. While we can maintain overall leadership, the gap will narrow. Japan is already graduating more engineers each year than the whole of the U.S. (with half the population base). In some areas, other nations will take the lead. We shall soon want to ensure access to new technologies in other countries, and we shall then be less worried about loss of our own technology to others.

But to reorient our nation to a faster rate of technological change requires different technology policies. We need to rethink how development of technology is to be financed; to what degree information can be shared among separate, even competing enterprises; how much cross-border cooperation will be essential; how much agglomeration and scale is necessary to compete with non-U.S. giants; how we insure development of proprietary technology in areas where public policy traditionally has sought rapid dissemination.

Our public policy in communications has brought about a decision to force the Bell System to divest its operating companies. This will drastically curtail the funding of Bell Labs, the research of which has traditionally been supported by the enormous cash flow of the combined services of the Bell System.

Bell Labs is the pre-eminent research institution in the world. The technology of many other companies depends on its research and licenses. To sustain Bell's future research, new sources of funds have to be found. In my opinion this must come from sale of hardware and services by Bell which embody proprietary Bell technology. A bill pending before the House, H.R. 5158, would prevent Bell Labs from turning in this direction, because it would force Bell Labs to disclose its pre-patent technology publicly and license all its patentable technology to all comers. This would cripple Bell Labs, remove its research incentive, and therefore do severe damage to American technological competitiveness, while automatically strengthening our competitors in other nations, especially in Japan.

Our public policy here has been viewing the Bell System in terms of the problems of yesterday, and today, within the boundaries of the U.S. and its geographic regions. The real policy issues ought to be how to cope with competition from

abroad, and how to assure Bell's continued world leadership in technology.

That is but one example of what I mean when I say that we fail to look ahead in making policy. This allegedly domestic policy issue is really a key question for our international economic policy.

Thus, I should like to see a fundamental shift in our economic policy perspective, to recognize the existence of a global marketplace, and to recognize the awesome challenges of the next few years from technology and from new sources of competition -- challenges which can already be foreseen.

Our international negotiating efforts should be developed with this kind of forward perspective.

And our Western Summit meetings should result in lifting our eyes beyond our feet, to the challenges and opportunities of the next few years. If our leaders look forward, they will recognize that the current problems of steel, autos, and microchips are only symptoms of the major changes coming. Better that the Western nations deal with these in concert, than in conflict.

There are big issues of East-West policy that divide the U.S. and Western Europe at the Versailles Summit -- export of

technology, credits to Eastern Europe, energy dependence, etc. In my judgment, the Soviets face enormous and growing economic problems, and a widening foreign exchange gap in coming years. Whatever our East-West policies, they will have only a modest effect on the coming deterioration in the Soviet Bloc.

Consequently, it seems to me far preferable to avoid a U.S.-European clash over policies towards the East, and instead focus on keeping the Western economic system together, strong, and growing. A strong West is essential to bargaining effectively with the East. A divided West is inevitably a weak West.

That requires thinking about international economic policy in a forward perspective. It requires consensus building among the Western nations, so that we can negotiate a better framework of cooperation in coping with the challenges ahead.

Responding to complaints about foreign practices, as we do today, is simply not a sufficient basis for making foreign economic policy.

We cannot run well by looking back. We should not make policy or negotiate on the basis of perceptions of problems of yesterday or today, but rather on the problems of tomorrow.

Representative REUSS. Thank you very much, Mr. Malmgren. Mr. Fox.

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT FOR INTERNATIONAL AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, D.C.

Mr. FOX. Mr Chairman, I'm Larry Fox, vice president for International Economic Affairs. I appreciate the opportunity to testify today on behalf of our association which represents 1,200 American industrial producers and collectively represents 80 percent or more of U.S. industrial output, and perhaps 85 percent of manufacturing jobs.

NAM member companies are an important factor in U.S. trade performance, perhaps representing as much as $125 billion of exports in 1981 and over 4 million jobs in the United States. I think we have learned that it is difficult enough to deal with the consequences of economic interdependence in good times. We have yet to learn how to work together in bad times to overcome the intensified strains placed on the world trading system and the international monetary system.

We seem to be at a loss to how to contain the ever more pronounced manifestations of economic nationalism that now characterize the policies of important countries. For these reasons, I think the hearings of this committee are extremely important. I commend the chairman and the committee for going forward with them.

From the NAM point of view, we are keenly aware of the importance of maintaining an open and impartial international trading system, one that establishes agreed-upon norms for commercial conduct among nations and mechanisms for enforcing them. The system, of course, should not itself unduly influence the distribution of trade benefits among the participants. Further, the international monetary system must be made to function more effectively in expressing, through exchange rate relationships, the real changes in competitiveness among countries, if the GATT system is to be made capable of surviving and to prosper.

Turning directly to the Versailles Summit, I think it is appropriate that this summit be a rerun of Ottawa insofar as discussion of the right mix of fiscal and monetary policy in the United States is concerned. It is not unthinkable to me that the viewpoints of the leaders of other industrial countries could enlighten or influence the thinking of the President of the United States regarding both domestic and international consequences of our most fundamental macroeconomic policies. These have resulted in high interest rates, recessionary conditions, high unemployment, a great reduction in inflation, and a very strong dollar. They have been applied quite neutrally, however, and have not been larded with subsidized exports, import controls, or disguised efforts to export our unemployment.

The U.S. exporter has hardly benefited from the strong dollar and the budgetary restraint on the Export-Import Bank.

FOCUS SUMMIT ON JAPANESE ECONOMIC POLICIES

I think it is important that the summit focus not as it has in the past exclusively, or to a great degree in the past on the United States—that it also turn its attention to Japan. It is for that reason that I

welcome a summit discussion of U.S. general economic policy, one that deals with both its internal and external effects.

I would urge that a comparable degree of attention be accorded the economic policies of another summit country, namely Japan. Policies that threaten the stability of the trading system must be challenged, particularly when the goals they support are at odds with the goals of the trading system as a whole.

I should make it clear that the survival of the GATT system, as we know it, may depend upon the willingness of Japan to make dramatic changes in what she may regard as purely domestic policies. I am sure the committee is well aware of the spate of so-called reciprocity bills before the Congress. Many of them, for example, Congressman Schulze's Complimentary Trade Preservation Act, are aimed specifically at Japan. All of them appear to have been inspired by the pattern of United States-Japan trade. The string of U.S. deficits with Japan, over $18 billion in 1981, is perhaps the best-known symptom. The concern, though, is as much with the character of the deficits as with their size.

Specifically, one, they have been due in large measure to the serious undervaluation of the yen. Second, more than half of Japan's exports to the United States are in such products as cars, trucks, steel, and electronics, where the competing U.S. industries are in serious or even severe difficulty; that much of Japan's trade success can be traced to internal and export credit practices, characteristics of a more directed than a free market economy; and finally, that Japan's low propensity to import manufactured goods is contrived and detrimental to the interest of the United States.

The European community is just as frustrated as we are, so much so that they have formally taken Japan to the GATT under article XXIII of the GATT. This article sets out a course of action for contracting parties that GATT members are to follow, when in their view the advantages won at the negotiating table are not being accorded in practice; when, in the language of the agreement, there is nullification or impairment of a trade benefit.

The European community's complaint is that "the GATT objective of reciprocal and mutually advantageous arrangement" has not been adequately achieved between the European community and Japan. The European community's argument seems to be that trade negotiations are predicated on a set of macroeconomic assumptions about the way societies work, in the case of Japan, the way a modern industrial society works. They then adduce evidence suggesting that Japan does not function as it might reasonably have been expected to do.

JAPAN'S LOW PROPENSITY TO IMPORT

Their observations include these: Japan's low propensity to import manufactured goods. It appears, for example, that whereas European imports of manufactured goods as a percentage of GNP almost doubled in the period from 1960 to 1980, that is, went up from 3.3 percent to 6 percent of GNP, in the United States they more than doubled, that is from 2 to 4.3 percent of GNP; in Japan they increased from only 2.4 percent to 2.5 percent.

JAPAN'S LACK OF EFFECTIVE ANTITRUST POLICIES

Second, sectoral oligopolies in Japan and the lack of effective antitrust policies serve to limit imports into that country.

PROTECTION OF JAPANESE INDUSTRIES

Third, key Japanese industries, like automobiles, electronics, and computers, benefited greatly from protection from European and American competition.

UNDERVALUED YEN

And fourth, the chronically and now very seriously undervalued yen referred to in the European community's submission as a sui generis currency tends to dampen the demand for Japanese manufactured imports and to give Japanese exports a significant advantage in every market of the world. The EC notes that "the yen does not play a role internationally commensurate with the strength of the Japanese economy."

Having mentioned perceptions here and abroad of the problems posed by the combination of Japan's phenomenal success as an exporter and curious aversion to imports, I should like to discuss briefly at this point the responses appropriate to the Congress in connection with the reciprocity bills now being considered. I wrote last week to the chairman of the International Trade Subcommittee of the Senate Finance Committee concerning the reciprocity bill. I did not urge passage of any reciprocity legislation nor does the NAM do that.

There are two reasons for this. First, the legislation, rightly or wrongly, has become associated with protectionism. Second, we are not persuaded that the administration needs additional law to deal with our international trade problems at this time, though we recognize the need for new international trade law in the GATT in the investment area. We do not recommend that our trade negotiations should be—we do, however, recommend that our trade negotiators be encouraged to join the Europeans in their use of GATT article XXIII and to work through some form of comparable GATT approach.

If such course is not adopted, it is all the more important that the administration find some way of making it clear to Japan that there are limits to the amount of export led growth a country with 2 percent unemployment can expect to achieve by exporting to countries with 9 to 13 percent unemployment.

A society like Japan with a 1980 trade surplus in manufactured goods of 93.7 billion, projected to be over 100 billion in 1981, and exports to imports ratio of manufactured goods of 4 to 1, must be doing something right. It must also be doing something fundamentally wrong.

Turning to the yen, the first set of Japanese polices that need to be looked at are those affecting the value of the yen. Mr. Bergsten has pointed out the yen-dollar rate is "the single most critical variable" in what he calls the "United States-Japanese economic conflict." I strongly agree with his view. This is one reason for looking at the yen now.

A second is that there is a more widespread agreement, even in Japan, that the yen is grossly undervalued. In urging discussion of

this issue at the summit, I would note that there are additional correctives available if the discussion at Versailles does not persuade the Government of Japan to take further action to bring the yen into line with the realities of Japanese competitiveness.

NO RELATIONSHIP BETWEEN EXCHANGE RATE AND COMPETITIVENESS

The latest Morgan Guaranty report gives one a true sense of the problem. The report analyzed the movement of various currencies since the 1970s, using 1973 as the base year. That is, 1973 equals 100. The dollar's real effective value in April 1982 was .114, and the yen's was 86.2. One must ask whether this represents the real world. Has U.S. competitiveness improved by almost 15 percent since 1973 and Japan's deteriorated by 14 percent? I think not.

This is not a problem that U.S. interest rates have created or can correct, although certainly high interest rates exacerbate the problem. A good deal of undervaluation of the yen is directly traceable to Japanese policies. To the extent that these reflect the objective of holding on to trade advantages of an undervalued currency, they are fair target for attention in the international monetary fund in connection with review under article IV of the IMF articles of agreement. This prohibits signatories from manipulating currencies or taking other action to achieve "unfair comparative advantages" in trade.

Additionally, article IV calls for IMF surveillance over exchange rate policies for a number of reasons, including "behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions, including factors affecting competitiveness and long-term capital movements."

I have discussed the yen problem perhaps more fully in a speech I gave to the conference board earlier this year, Mr. Chairman, and I would hope you would make it part of the record.

Representative Reuss. Without objection, that will be included in the record at the conclusion of your testimony.

Mr. Fox. Thank you. I would like to turn to two other matters concerning export competitiveness.

EXPORT CREDITS

First, export credits. Certainly there is more to be dealt with at Versailles than Japan. There is, for example, the persistent problem of export credits. The expression of determination to solve the export credits problem shows up regularly in the summit communiques, and some progress has been made, but it is progress that has little to do to protect U.S. economic interests. These interests must be protected either through strengthening the Export-Import Bank or through a sound and effective international agreement. I personally doubt that we can achieve the latter, unless it is clear that we are willing to resort to the former.

It is worth remembering that American workers have paid with their jobs for the failure of these mechanisms to resolve the international credits war. A recent survey of the Machinery and Allied Products Institute, for example, indicates that many U.S. companies routinely divert export orders to foreign affiliates in order to obtain competitive export financing. Their survey, which covered only 39 companies,

identified $386 million in export orders that were shifted to foreign affiliates in 1981 alone, because of the financing available abroad being more attractive than at home.

The problem is so endemic and the response so routine, that the study almost certainly understates the problem even for the firms covered. Even so, $386 million in lost orders is not peanuts. In accordance with Commerce estimates of job effects of exports, it represents over 13,000 jobs.

The GATT ministerial meeting to take place in November represents an important challenge to improve the operations of the world trading systems. The GATT conference must first make certain that previous agreements negotiated in the GATT, particularly the nontariff barrier agreements and the multilateral trade negotiations noted in the Government procurement code and the antisubsidy code, are really made to bear fruit. It's far from the case as yet.

MULTILATERAL IMPORT SAFEGUARDS CODE

A second deficiency in the MTN should be addressed, including the failure to negotiate an effective multilateral import safeguards code under the GATT and failure to complete the code with respect to counterfeiting. But the ministers must go beyond making the previous agreements work. They must look to the problems of the future, particularly new rules with respect to international trade and services and fair treatment of international investment. The growth in the service industries around the world and in performance requirements increasingly being applied to extranational investment underscore the need for work in the GATT in this area. In doing so, we need to be mindful that in debating the issues involved in negotiation of these codes, the GATT members will be debating the premises and limits of the economic nationalism that is already guiding the economies of most GATT countries. It will be slow going.

Success in all of these areas depends ultimately on the political will of the participants. The Versailles summit offers the next major opportunity for testing whether the leading countries are prepared to support, rather than simply endorse these objectives. We hope the summit can help create the political will necessary to go forward with dealing effectively with the trade problems of the 1980's and 1990's.

In closing, I would like to reiterate two points. The first is what I believe to be the view of American industry: namely, that Japan is a destabilizing force in the world trading system. We sincerely hope as a result of the Versailles summit, the Japanese Government will become convinced of the need to alter its destabilizing policies and to dedicate itself to a more constructive role in the world economy.

Second is that the exchange rate mechanism is not working, as it affects trade. This calls for a more effective alinement and realining of currencies so that they do, in fact, reflect fundamental changes in international competitiveness.

As we discuss this matter in the course of these hearings, Mr. Chairman, I would be pleased to elaborate my views on what is to be done. I want to thank you again for having these hearings and inviting us to testify.

[The prepared statement of Mr. Fox, together with attachments, follows:]

Prepared Statement of Lawrence A. Fox

Mr. Chairman, members of the Committee, I am Lawrence A. Fox, vice president for international economic affairs at the National Association of Manufacturers. I am indeed grateful for this opportunity to express our concerns about some of the matters we expect will occupy President Reagan and the leaders of Canada, France, Germany, Italy, Japan the United Kingdom when they confer next month at Versailles. I would agree with those who have suggested that this will be the most critical of the summits since these yearly conferences were begun in 1977.

We have learned that it is difficult enough to deal with the consequences of economic interdependence in good times. We have yet to learn how to work together to overcome the intensified strains placed on the world trading system and the international monetary

system in the midst of bad times when the world scene is characterized by economic recession or very slow growth. Particularly, we seem to be at a loss to contain the evermore pronounced manifestations of economic nationalism that characterize the policies of important countries. It is for these reasons I think these hearings, which should help to illuminate the nature of the problems to be dealt with in Versailles, are very important. The Committee should be complimented for holding them.

The National Association of Manufacturers represents over 12,000 American producers. Collectively these firms account for approximately 80% of U.S. industrial output and 85% of U.S. industrial employment. Because most of America's leading exporters are members of NAM, the inferences to be drawn from the published data--namely that exports by NAM members were more than $125 billion in 1981 and provided more than 4 million jobs--probably understate the reality.1/

Similarly, the problems associated with imports are problems of survival for many NAM member companies.

We are, therefore, keenly aware of the importance of maintaining an open and impartial international trading system, one that establishes agreed upon norms for commercial conduct among nations and mechanisms for enforcing them. The system, of course, should not itself unduly influence the distribution of trade benefits among the participants.

1/ According to a recent Commerce Department survey "Origin of Exports of Manufactured Products" 4.8 million American jobs were devoted to producing for export in 1980.

Further, the international monetary system must be made to function more effectively in expressing through exchange rate relationships the real changes in competitiveness among countries if the GATT system is to survive and prosper.

Mr. Chairman, there are two fundamental questions of international economic policy I am confident the leaders at Versailles will discuss, if only implicity, and equally confident they will not resolve. They are these: To what extent are the domestic economic policies of one nation the legitimate concern of others? and to what extent should these policies be influenced by international considerations?

I believe these parallel two of the issues raised in the Chairman's letter inviting me to testify, namely:

1) the costs U.S. macro-economic policy has imposed on the international economy; and

2) the strains foreign and U.S. policies have put on the international trading system.

Certainly, domestic economic policy issues were high on the list of topics at Ottawa. The following phrases, all from the first page of the declaration of the Ottawa summit, make the point.

"The fight to bring down inflation and reduce unemployment must be our highest priority...The balanced use of a range of policy instruments is required."

"We need in most countries urgently to reduce public borrowing."

"Most of us need also to rely on containment of budgetary deficit, by means of restraint in government expenditures as necessary."

I have not listed these statements to quarrel with them; each has merits in its own right. Taken together what they reflect most profoundly is the anxiety about U.S. interest rates expressed unhesitatingly by our summit partners in Ottawa last July. Before commenting further on them, I should like to share with you a quite separate observation on one result of an even earlier summit.

As you may have seen, Germany's newly appointed Minister of Finance, Manfred Lahnstein, told the Bundestag earlier this month that Germany had erred in allowing itself to be persuaded by its 1979 summit partners to reflate. The DM 13 billion invested in stimulating the economy, he said, increased Germany's inflation and did little to pull Western Europe into prosperity as it was intended to.

In a general sense, I think Mr. Lahnstein is right. After keeping the peace, providing a strong, employment-rich domestic economy is the primarly challenge confronting democratic, market-oriented societies. The goal is more likely to be achieved through policies that address it directly than through reactions to external concerns. I am not suggesting by this that U.S. interest rates, still high and still very much on the minds of our trading partners, should not be discussed at Versailles. It would in any case be a pointless suggestion

From this standpoint I think it is quite appropriate that Versailles be a re-run of Ottawa insofar as discussion of the right mix of fiscal and monetary policy in the United States is concerned. It is not unthinkable to me that the viewpoints of the

leaders of other industrial countries could illuminate the thinking of the President of the United States regarding both domestic and international consequences of our most fundamental macro-economic policies. Our policies have resulted in high interest rates, recessionary conditions, high unemployment, a great reduction in inflation, and a very strong dollar. These policies have been applied in a quite neutral way, however, and have not been landed with subsidized exports, import controls, or disguised efforts to export our unemployment. The U.S. exporter hardly has benefited from the strong dollar and budgetary restraint on the Export-Import Bank.

Accordingly, I welcome a summit discussion of U.S. general economic policy as to both its internal and external effects. I urge that a comparable degree of attention be accorded to the economic policies of another summit country, namely, Japan. Policies that threaten the stability of the trading system must be challenged, particularly when the goals they support are at odds with the goals of the trading system as a whole.

Insofar as Japan is concerned, I think it should be made clear to the members of the Japanese summit delegation that continued usefulness of the GATT trading system as we know it, if not its survival, may depend upon the willingness of Japan to make dramatic changes in what she may regard as purely domestic policies.

The signs of discontent with the role Japan has played in recent years are legion. Members of the Committee are, I am sure, well acquainted with the spate of so-called reciprocity bills. Many of these, like Congressman Schulze's Complementary Trade Preservation Act are aimed specifically at Japan. All of them appear to have been inspired in large measure by the pattern of U.S.-Japan trade. The string of American trade deficits (18.1 billion in 1981) is perhaps the best known symptom. The concern though, is as much if not more with the character of the deficits as it is with their size, specifically:

- that they are in large measure due to the serious under-valuation of the yen, which has persisted over the years and has recently grown worse;

- that more than half of Japan's exports to the United States, which totalled $37.6 billion in 1981, are in products such as cars, trucks, and steel where the competing U.S. industries are in severe difficulty;

- that much of Japan's trade success can be traced to internal and export credit practices characteristics more of a directed than a free economy. (I would note parenthetically that this point is dramatically illustrated by the study recently released by the Committee on "International Competition in Advanced Industrial Sectors: Trade and Development in the Semiconductor Industry"); and

- that Japan's low propensity to import manufactured goods is contrived and detrimental to the interest of the United States and other industrial countries.

This list of irritants in the U.S.-Japanese trade relationship echo a resolution on U.S. Japan Commercial Relations, which was adopted unanimously by the NAM Board of Directors on March 17. I should be grateful if this resolution (attached) could be included in the record as part of my statement.

The European Community is just as frustrated as we are; so much so that they have formally taken Japan to the GATT under Article XXIII. This sets out a course of action for contracting parties, that is GATT members, to follow when in their view the advantages won at the negotiating table are not being accorded in practice, when in the language of the Agreement there is "nullification or impairment" of a trade benefit. The European Community's complaint is that:

> "...the benefits of successive GATT negotiations with Japan have not been realized owing to a series of factors particular to the Japanese economy which have discouraged imports of products other than raw materials. As a result of this situation, combined with the pattern of growth of Japanese exports to the European Community, the GATT objective of 'reciprocal and mutually advantageous arrangements' has not been adequately achieved between the European Community and Japan."

The essence of the EC's argument seems to be that trade negotiations are predicated on a set of macroeconomic assumptions about the way societies work, in the case of Japan the way a modern industrial society works. They then adduce evidence suggesting that Japan does not function as it might reasonably have been expected to. This evidence includes the following:

1. Japan's propensity to import manufactured goods is markedly lower than that of the European Community or the United States. This is so whether the index is manufactured goods imports as a percent of total imports; per capita imports of manufactured goods; or the change in manufactured goods imports as a percentage of GNP from 1960 to 1980. Taking only the last of these, it appears that, whereas European imports of manufactured goods as a percentage of GNP almost doubled in this period (i.e., went from 3.3% to 6.0%) and in the United States they more than doubled (i.e., went from 2.0% to 4.3%), in Japan they increased only from 2.4% of GNP to 2.5%;
2. sectoral oligopolies in Japan and the lack of effective antitrust or competition policies, such as exist in United States and Europe, serve to limit imports;
3. key Japanese industries like automobiles, steel, and electronics benefitted greatly from protection from European and American competition;

4. the chronically and now quite seriously undervalued yen, referred to in the EC's submission as a sui generis currency, tends to dampen the demand for Japanese manufactured imports and to give Japanese exports a significant advantage in every market in the world. The EC notes that, "the yen does not play a role internationally commensurate with the strength of the Japanese economy".

Having mentioned perceptions here and abroad of the problems posed by the combination of Japan's phenomenal success as an exporter and curious aversion to imports, I should like to discuss briefly proposed responses now before the Congress and the international trade community.

On behalf of the National Association of Manufacturers, I have written to Senator Danforth in connection with the hearings on "reciprocity" recently held by his Subcommittee on International Trade of the Senate Finance Committee. I suggested to him certain amendments to U.S. trade law that we would find helpful. I did not, however, urge the passage of any "reciprocity" legislation we have seen. There are two reasons for this. First, the legislation, rightly or wrongly, has become associated with protectionism. Secondly, we are not persuaded that the Administration needs additional law to deal with our international trade problems, though we do recognize the need for new GATT law in the investment area. In any event, we were not inclined to argue strongly in favor of legislation that does not have the full backing of the Administration.

We did, however, recommend that "our trade negotiators ... be encouraged to join the Europeans in their use of GATT Article XXIII or to work on a comparable GATT approach." My understanding is that the U.S. Trade Representative's office is reluctant to adopt such a course because to them it represents too sweeping an indictment of another country, of a close ally. I disagree. We cannot afford to deny ourselves legitimate GATT options for fear of giving offense. Both the GATT and the American business community's perception of its usefulness are too important.

If, however, such a course is not to be adopted, it is all the more important that the Administration find some way of making it clear to Japan there are limits to the amount of export led growth a country with 2% unemployment can expect to achieve by exporting to countries with 9% to 13% unemployment. A society, like Japan, with a 1980 trade surplus in manufactured goods of $93.7 billion (projected at over $100 billion in 1981) and an exports-to-imports ratio in manufactured products of 4 to 1 must be doing something right. It must also be doing something fundamentally wrong.

I suggested earlier that some policies are more properly the subject of international scrutiny than others. In dealing with Japan the first set of policies that need to be looked at by the summit countries and others are those affecting the value of the yen. I say this first because as Dr. Bergsten has pointed out the yen-dollar rate is the "single most critical variable" in what he has called "the U.S.-Japan economic conflict"; second, because at this time there is widespread agreement, even in Japan, that the yen is grossly

undervalued; and thirdly, because there are additional international correctives available to us if the discussion at the Versailles does not persuade the Government of Japan of the need to take further action to bring the yen into line with the reality of Japanese competitiveness. The latest Morgan Guaranty report gives one a sense of the problem. The report analyzes the movements of various currencies since the early 70s. Using 1973 as the base year, i.e.. 1973 equals 100, the dollar's real effective value in April 1982 was 114 and the yen's 86.2. One must ask whether this represents the real world. Has U.S. competitiveness improved by almost 15% since 1973 and Japan's deteriorated by almost 14%? I think not.

This is not a problem U.S. interest rates created or can correct, though certainly they exacerbate it. A good deal of the undervaluation of the yen is directly traceable to Japanese policies. To the extent that these reflect the objective of holding on to the trade advantages of an undervalued currency, they are a fair target for attention in the International Monetary Fund in conjunction with action under Article IV of the IMF Articles of Agreement. This prohibits signatories from manipulating their currencies or taking other action to achieve "unfair comparative advantages" in trade. Additionally Article IV calls for IMF surveillance over exchange rates policies for a number of reasons, including, "...behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long term capital movements."

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I have discussed Japan at some length because I believe the international trading system is in the midst of a crisis. Convincing Japan of the importance of assuming quickly the full measure of responsibility for that system that falls to her as the second largest and most dynamic economy in that system is the best hope for a satisfactory resolution of that crisis and the most important objective we can expect to achieve at Versailles.

Export Credits

Certainly, though, there are other international trade issues we would like to see the summit leaders discuss. One of these is the perennial question of export credits.

As you know, there have been a succession of international negotiations on export credit, but the "credit war" continues. This may be partly due to the fact that the perception of the United States as a "paper tiger" has yet to be seriously challenged much less disproven. At the 1980 Venice Summit, for example, the participants agreed to, "strengthen the international arrangement on export credits with a view to reaching a mutually acceptable solution covering all aspects of the arrangements by December 1980."

Then in 1981 the Ottawa summit leaders agreed to, "endorse efforts to reach agreement by the end of this year on reducing subsidy elements in official export credit schemes."

To be sure, some progress has been made but it is progress that has done little to protect U.S. economic interests. These interests must be protected either through strengthening Eximbank or through a sound and effective international agreement. I personally doubt we

can achieve the latter unless it is clear that we are willing to resort to the former. It is worth remembering that American workers have paid with their jobs for the failure to date to achieve either of these mechanisms to resolve the "credit war".

A recent survey of the Machinery and Allied Products Institute, for example, indicates that many U.S. companies routinely divert export orders to foreign affiliates in order to obtain competitive export financing. Their survey, which covered only 39 companies, identified $386 million in export orders that were shifted to foreign affiliates in 1981 because the financing available abroad was more attractive. The problem is so endemic and the response so routine that the study almost certainly understates the problem even for the firms covered. Even so $386 million is not penuts. Commerce Department estimates of the ration of export values to jobs suggest that it represents about 13,000 jobs.

The GATT Ministerial

The agreed purpose of the November GATT Ministerial is, "to examine the functioning of the multilateral trading system, and to reinforce the common efforts of the contracting parties to support and improve the system of benefits of all nations." That is a tall order. The challenge involved in reviewing and tightening up the implementation of the codes already agreed to would seem more than enough for the GATT ministers to attempt, but it is not. The government procurement code and the anti-subsidy code have yet to bear fruit in discernible changes in the way governments act to affect trade. The GATT Ministers must thus make sure their codes are

implemented and then go on to the realities of the 1980s and 1990s i.e., the increased role of governments to influence trade and economic development by means of nationalistic investment, finance, and sophisticated industrial policies.

It is, therefore, imperative that the ministers go beyond the codes of 1979 and attempt the laying of a firm political groundwork both for the unfinished business of the Tokyo Round--a meaningful safeguards code and a counterfeit code--and for the critical codes of the future on investment and trade in services. The growth in service industries around the world and in the performance requirements increasingly being applied to extra-national investment underscore the need to begin work in these areas. In doing so, we need to be mindful that in debating the issues involved in the negotiation of these codes the GATT members will be debating the premises and limits of the economic nationalism that already guides the economies of most GATT countries. It will be slow going.

Success in all of these areas depends ultimately upon the political will of the participants. The Versailles summit offers the next major opportunity for testing whether leading countries are prepared to support rather than simply endorse these objectives. We hope the summit participants will strive for a strong expression of political support for the goals of the Ministerial at the conclusion of their deliberations.

In closing, I would like to reiterate two points. The first is what I believe to be the view of American industry, namely that Japan is a destabilizing force in the world trading system. We sincerely

hope that as a result of the Versailles summit the Japanese government will become convinced of the need to alter its destabilizing policies and to dedicate itself to a more constructive role in the world economy.

Second is the exchange rate mechanism as it affects world trade. This must be made more effective in aligning and re-aligning currencies so that they do in fact reflect fundamental changes in international competitiveness.

Mr. Chairman, I would like to thank you again for this opportunity to express our views in connection with the forthcoming summit. I would, of course, be happy to respond to questions.

RESOLUTION
ON
U.S.-JAPAN COMMERCIAL RELATIONS

Whereas Japan's industrial, trade, investment, and financial policies have led to gross imbalances in Japan's trade with the United States and other industrialized countries;

Whereas certain of these policies, as manifested in unduly large global and bilateral manufactured goods trade surpluses, pose a threat to the world trading system and to the industrial base of the United States;

Whereas the National Association of Manufacturers, the principal representative of American industry, regards the health of the U.S. industrial base as fundamental to U.S. well-being and security; and

Whereas the NAM supports a market-oriented, open international trade and investment system;

Resolved that the National Association of Manufacturers should work toward the following goals:

- greater internationalization of the yen and a more appropriate yen-dollar exchange rate;
- reduced barriers to foreign investment in Japan;
- openness of Japanese markets for goods, services and capital equivalent to that of the United States and commensurate with Japan's standing as the second largest economy of the Free World and currently the most dynamic; and
- commitment on the part of the Japanese government and Japanese business to shoulder the full measure of responsibility for the world trading system that Japan's economic strength and stake in the world trade confer upon her.

NAM, working with the American government, will take appropriate steps to inform Japanese government and business leaders of our views and thereby help to bring about constructive solutions to our mutual problems.

Adopted by the
NAM Task Force on U.S.-Japan Commercial Relations
March 9, 1982

Adopted by the
NAM Board of Directors
March 17, 1982

Speech delivered by Lawrence A. Cox before the Conference Board's 1982 Financial Outlook Conference, New York, N.Y., February 25, 1982

A Stronger Dollar: How Durable?

There is a common perception that the dollar is overly strong. High U.S. interest rates are mainly responsible. It is also generally believed that big balance of payments deficits loom ahead for the U.S. in 1982 and beyond--mainly due to larger U.S. trade deficits, i.e. larger than our very large 1981 deficit. High U.S. interest rates worry the Europeans, as does the Reagan Administration's "refusal" to hold down the value of the dollar--a message delivered to the American Government last week by the President of the Common Market's Council of Ministers. Hence, conventional wisdom maintains that we can expect--and some would go so far as to say "welcome"--a weaker dollar. I do not join in the clamor for a depreciated dollar. Quite the opposite. I want to discuss with you today why a strong dollar in international money markets is in our national interest, and how we should go about achieving this result.

Now that I have set the scene, I will turn directly to my subject "A Stronger Dollar: How Durable?" The first benchmark we need to focus on relates to what we mean by a strong dollar. In other words, the dollar compared to what: stronger than last summer's dollar or when it was in the pits in 1978, and again in 1979? Or the dollar in relation to the currencies of the other two world-class industrial trading countries, Japan and Germany? Or in relation to the Morgan Guaranty's well-known fourteen-country trade weighted average?

The dollar quite obviously is relatively strong at present. For this presentation, therefore, we will define a strong dollar as basically the dollar we have today. In other words, a dollar not so strong as it was under the fixed parity system of Bretton Woods prior to August 15, 1971 nor at its most recent lofty heights.

Along with the rough definition of what I mean by a strong dollar I must, of course, provide a time frame. I am talking about the trend for the whole decade of the 1980's. Obviously, this trend will not always be steady or consistent. The experience of the past few years has amply demonstrated that currencies tend to overshoot in a floating exchange rate system. Under these circumstances we can expect ups and downs in the value of the dollar, but nevertheless when you average out the ups and downs we are likely to see a strong dollar for most of the 1980s.

My basic economic outlook for the 1980s is the following: I think the fundamental conditions that prevail in the United States vis-a-vis the world economy signal a relatively better performance by the American economy than the economies of most other countries, certainly most other countries in the OECD. The economy of Japan will do better than that of the U.S., and possibly but much less certainly, so will Germany's. But an improved, more healthy U.S. economy would, I believe carry with it the implication of a stronger dollar.

Having given you my economic outlook and assumptions, I want to state at the outset that I favor a strong dollar. I do not see how our country can fight inflation successfully without a strong dollar at home, and I do not see how the United States can readily have a weaker dollar abroad and a stronger dollar at home. I suggest from this that we have no alternative other than to seek a strong dollar internationally as well as domestically so long as our objective is to succeed in the fight against inflation.

The mistake we made in the 1970s was to rely on a weak dollar to solve our trade problem. This strategy may have helped to some extent to increase our export competitiveness, but it by no means solved our trade problem and it did make our inflation problem worse. To the extent that a strong dollar is the result of a healthier American economy reflecting increased competitive strength, we have little to fear from it and no reason to weaken it.

I have some reasons for my opinions beyond prejudice, and I would like to indicate briefly the factors that can make and keep the dollar a strong currency during the 1980s. In other words, why a "strong dollar is durable."

First, I expect real interest rates to continue to be rather high in this country. By that, I mean real interest rates--representing the differences between nominal rates and the inflation rate--in the U.S. relative to other countries willing to absorb large amounts of capital. Under these circumstances from the interest rate standpoint, I do not expect on balance over time that dollars will leave the country to seek higher returns abroad in sufficiently large quantities to become a major factor working to weaken the international value of the dollar. I think that nominal interest rates in this country, although declining, will still be relatively high regardless of the real interest rates.

Second, money will stay in the United States for conventional reasons, namely, a good return on capital invested here and because of the factor of safety. I think the international political environment is such that there is a degree of sensitivity around the world which leaves many people who dispose of their own and other people's money with the idea that they should have a good part of their assets denominated in dollars, and, in fact invested in the United States if possible.

Third, I think that factors in our trade performance can work--must be made to work--in the direction of a stronger dollar. An improved U.S. trade performance could support a strong dollar not only for obvious balance-of-payments reasons, but also through improved domestic economic performance. Trade performance in this view includes improved export performance as well as more successful domestic market response to import competition in manufactured goods, thus halting the unnecessary and harmful erosion of the American industrial base through loss of domestic market shares to imports. But this improved U.S. trade performance will not take place if we have another decade of a seriously undervalued yen relative to the dollar.

I will be developing the point of the yen-dollar exchange rate further. However, I would like first to comment briefly on the broader question of how I view the balance of payments from a policy standpoint--as distinguished from the usual national accounts or technical standpoint.

A Different Perspective on the U.S. Balance of Payments

The interaction of trade and finance is a subject which I think is increasingly recognized to be of much greater importance than the current general understanding of the issue requires. The analysis of balance of payments in this country, in the IMF and private banks, and in the government and academe , is based on a conventional current account financial methodology. In this approach what really counts in determining the value of a country's currency relative to that of other countries turns on the current account and the build-up or decline in foreign currency reserves. This is what I call the "financial approach" to the balance of payments. I do not denigrate this approach.

Since this approach to the balance-of-payments and consequentially currency values and the exchange rate is well understood in this audience, I will not elaborate on this generally accepted approach. What I think is less well understood is the relationship between general economic performance, trade performance, and the strength of a country's currency. I think most of us would agree that the United States economy has performed rather poorly in the industrial sector relative to Japan and Germany. As a nation we have also done quite well at home and abroad in the service sector and in the international investment area. As a consequence we have had a good record in our current account in 1980 and 1981--albeit with the help of an official accounting change in 1978 in the definition of retained earnings held abroad by American foreign subsidiaries. Parenthetically, this piece of "creative accounting" of the Carter administration has produced a net continuing plus in the order of $12 or $13 billion in the U.S. payments balance. However after two or possibly three years of current account surpluses, virtually all analysts in and out of government are predicting a major current account deficit this year--almost entirely due to the downward thrust in our trade balance.

I would like to suggest an alternative to the financial approach to the balance of payments--a policy viewpoint, not a different accounting methodology. For lack of a better term, I would call it a trade-oriented economic growth approach. To give a real-world flavor to my observations, I would call the Japanese and German policy preference as trade-oriented while referring to the traditional American and U.K. perspective as exemplifying the financial approach. The trade-growth approach gives special weight to the importance of the contribution of the trade account in assessing the over-all quality of the balance of payments performance of a country.

Let me hasten to assure you that there is more to the trade-growth approach than the traditional unsophisticated view that a trade surplus is always better than a trade deficit. One way or another we all have to pay our oil import bills. Japan and Germany knew from the beginning that they had to pay for the high-priced oil and launched and maintained highly successful export drives to do so. In the process, they have captured markets from us not only in their own lands and in third world countries, but in the United States as well. In these countries export-led growth has come naturally--as both a slogan and a policy.

A few numbers will illustrate my point. If the United States had maintained in 1980 the share of world manufactured goods markets we enjoyed in 1970 (21.3 percent as against 18.3 percent), it would have meant an extra $23.6 billion in our manufactured goods surplus for 1980 (census basis) and thus would have eliminated the trade deficit. In other words, had we held onto our 1970 world market share of manufactured goods, our 1980 exports would have paid for all our imports: oil, cars, steel, consumer goods, everything. It is an unfortunate but widely held view that trade is very important for most countries but not for the U.S. Also, there is a tendency in this country to fail to understand the impact that American export expansion can have on domestic growth rates. After all, what difference can $30 or $40 billion additional export sales make in a

$3.5 trillion economy? The answer is a significant one. If the U.S. export growth rate of 1980 had been maintained in 1981, it would have meant a full percentage point in the rate of growth in U.S. GNP. In 1982, it could make the difference between an economy enjoying at least a bit of growth, rather than one actually in recession, as ours now is, of course.

To summarize, when I refer to a trade-oriented policy perspective rather than a financial approach to the balance of payments, I am suggesting no less than this: a whole generation of American economists, American foreign policy officials and financially oriented American institutions have underestimated the importance of the trade account from the standpoint of judging the quality of American economic performance. I hope we have begun to realize that "doing well" economically takes more than the premature celebration of the post-industrial society. The decline in productivity growth that became evident in the 1970s--in all sectors but particularly the industrial sector--has its consequences in terms of domestic economic growth, inflation, and employment. In my view, the revitalization of American industry can take place only in the context of new investment in the U.S. to supply the world markets, not just our home market. More than 20% of our manufactured goods output is exported and roughly the same proportion imported. If we could raise the export level to 25% and hold it there, (a not too difficult task), that would increase GNP in real terms by 1.2 percentage points. Over time that might be enough to change lackluster economic growth into reasonably satisfactory national economic performance.

And what would this do to productivity growth in the industrial sector? New investment in American industry can increasingly be justified only in relation to the global market, not just the U.S. home market. New American investment in plant and equipment should be materially encouraged by our new accelerated depreciation and other business tax law changes. And this new investment in high productivity plant and equipment thus must be validated by improved competitive prospects--market shares if you will--in the home market as well as in foreign markets. That is what

export-led growth is all about. For Japan and Germany quite clearly it has meant new home investment and newly applied technologies to achieve the necessary economies of scale to hold on to domestic market shares while maintaining or increasing export market shares.

Is The Dollar Really Over-Valued?

There has developed a type of conventional wisdom concerning the value of the dollar. Because currency markets tend to overshoot in a floating system, the dollar clearly was too weak in the fall of 1979. The dollar strengthened following the adoption of the comprehensive monetary policies by the Volcker Federal Reserve and the Treasury Department in 1979. The dollar has strengthened and held its own from 1979 to the present day. Of course, the dollar strengthened even further as interest rates took to new heights following the election and inauguration of President Reagan.

But is the dollar really over-valued today? Has the overshooting now taken place on the high side in distinction with overshooting on the low side in the fall of 1979? Let me suggest that actually the dollar may be about "right" and that there is one currency that is seriously undervalued--the Japanese yen, and a second currency, the D-mark, which is undervalued but perhaps tolerably so.

To simplify this presentation I will confine my comments to the yen, which makes the subject easier to analyze and also makes policy prescription more straight forward. I would further suggest that, based on competitive factors, the yen has been systemtically undervalued since 1973.

Let us look at some specific indicators of U.S. and Japanese industrial competitiveness so that you can see what I mean. The original Bretton Woods dollar-gold parity came to a screeching halt on August 15, 1971, with roughly a 10% devaluation of the dollar, a 7% appreciation of the yen, and the up-valuing of certain other currencies--all this ratified in December 1971 by the so-called Smithsonian agreement. In 1973, the major western industrial countries and Japan de facto terminated the

Bretton Woods system of fixed exchange rates, and went to a system called "floating" but in fact one that more aptly can be regarded as a mixed system of managed market-determined rates. From March 1973 to mid-1981, the yen appreciated from 265 per dollar to 220, though in the near-panic days in 1979 it had briefly reached near 180. But over the same eight year interval, the volume of Japanese manufactured exports increased at an annual rate of 10.1% compared to 4.6% for the U.S. If the yen had appreciated at the rate of relative change in export volume, the implied 1981 yen-dollar rate would have been 177 instead of 220. We find a similar story if we turn from volume to export prices, on a national currency basis, to test the effect on exports of domestic inflation rates. While the Japanese consumer inflation rate overall since 1973 has been approximately the same as in the U.S.--due mainly to a big surge in Japan in 1974--manufactured export prices have only increased by 7.1% per year, or almost five points lower than the U.S. rate of 11.8% per year. On this basis, the implied yen-dollar rate for 1981 would have been 189 instead of 220. Finally, let us consider overall productivity growth in terms of manufacturing output per man-hour (for which the latest comparative Labor Department statistics are complete only through 1980). In the period 1973-80, the annual U.S. growth rate in productivity was 1.7%, compared with 6.8% in Japan. On this basis, the implied value of yen in 1980 would have been 193 per dollar, in contrast to an actual average 1980 value of 227.

Naturally, I do not purport to be able to pick the one and only "correct" yen-dollar exchange rate, if indeed such a thing really exists, which I doubt. But I would cite a few yen "undervaluationists" whose words come readily to hand:

- Morgan Guaranty in its "World Financial Markets" of January 1982, when the yen was at about 220, suggested that "yen appreciation on the order of about 10% in real effective terms would provide a very appropriate market-assisted means of bringing mounting trade surpluses under control."
- Paul W. McCracken, former Chairman of the Council of Economic Advisors stated in September 1981 in Japan that "the present rate of 235 yen to the dollar is perhaps 15% or so below what many consider to be a more equilibrium purchasing power relationship."

- A recent Department of Commerce study's preliminary results which indicate that "the Japanese yen is substantially undervalued relative to the U.S. dollar--roughly 23% in 1981."

I am inclined to believe that the degree of undervaluation of the yen falls in the higher rather than the lower end of the range of the figures just cited.

Why Has The Yen Been So Weak?

I have been giving you a trade-oriented view of exchange rates and will continue to do so in explaining why the yen has been and continues to be undervalued. (Incidentally, what I have to say should be read in conjunction with a most thoughtful analysis in Janaury's Morgan Guaranty World Financial Markets entitled "Japanese Trade Frictions and the Yen.").

The major factors in post-war Japanese economic policy are well known--macroeconomic policy, monetary policy, demand management, savings, investment, innovation, etc. In referring to exchange rate policy in relation to trade I am attempting to illuminate an aspect that is to my mind unaccountably overlooked by most observers--to make a pun, an element of analysis that has been undervalued.

Japanese post-war economic strategy has in a critical sense been based on trade and investment. (The acronym--MITI--after all stands for the Ministry of International Trade and Investment.) Painting the picture in broad strokes, I would say that a basically protected home market in manufactured goods has in effect produced "monopoly profits", not to individual companies per se but to Japanese industry as a whole. These profits, of course, could be and were reinvested in Japanese industry. Exports could be competitively or even marginally priced if necessary--thus making possible longer production runs and lower unit costs, and often resulting in even higher profits on domestic sales. Government policy encouraged constant and accelerating up-grading of value-added skills in ever higher capital intensive and technology-oriented industries. To make sure that exports really could effectively

penetrate foreign markets, costs were reduced further by "targeting" key industries for development at home and for export growth in major foreign markets. On top of all this, the export price was "right"--guaranteed until August 15, 1971 by an over-valued dollar under the fixed parity Bretton Woods system; and since then by a continuation of Japanese government financial policies designed to keep the yen undervalued.

Obviously Japanese authorities are a bit embarrassed at this point with the distressingly speedy turn-around in their trade balance--converting a $5 billion trade deficit into a $25 billion trade surplus in a year and one-half. Exports rose at a 25% rate while imports stagnated in this same 1980-81 period. It appears that perhaps virtually all significant manufactured goods made in Japan today can be sold on the export market. As I have explained, the reasons are not so difficult to grasp in terms of macro-economic policy in Japan, but they can only be fully comprehended in terms of continuity of exchange rate policy for a period of 30 years. The yen as a policy instrument has been undervalued not only making Japanese goods price competitive in world markets but also making imports correspondingly more expensive and less attractive on the Japanese market.

The yen-dollar rate is, of course, central to the trade strategy I have outlined. However, the cross rates with European currencies, being to a great degree determined by the dollar's exchange rate with the principal European currencies, tend to replicate more or less the conditions of an undervalued yen in relation to major European currencies, and thus to place very low priced Japanese goods in the European market. Hence the emergence of huge Japanese trade surpluses with Europe as well as the U.S.

Naturally, the question must be asked, how does all this come about? Is not Japan part of the world monetary system? The answer may be given in three parts:

1. Perceptions have been slow to change as to the "true" value of the yen.

2. The Japanese capital market is not an open one in either the New York or London sense, nor to the degree of typical European or Asian financial markets.

3. Intervention by Japanese authorities in currency markets has been purposeful, i.e. intervention has not only smoothed the ups and downs of the yen relative to the dollar, it has nipped in the bud any major corrective market action to appreciate the yen.

The days of October 1979 when the yen briefly rose to a value of 170-180 to the dollar truly tested the Japanese resolve to keep the benefits of a depreciated currency. They succeeded. That resolve is being tested again today when every financial and trade signal points in the same direction. The yen is so seriously undervalued today that the question begs to be answered: What can be done to make it appreciate?

I conclude these remarks with the answer. It is really a prescription.

1. Open Japanese financial markets and the yen will appreciate. Interest rates will rise in Japan and Japan's savings will be shared with others, just as has taken place in other countries.

2. Stop the intervention by Japanese monetary authorities designed to keep the yen low in value.

The yen will appreciate as Japanese financial markets are opened further, particularly as foreign borrowings become a business decision rather than a decision of high national policy with concomitant bureaucratic consultation, consensus-building, and the usual inordinate delay. As Japan joins the real-world monetary scene, interest rates will rise. It will be more difficult to carry out an independent, insular domestic monetary policy, and life for the monetary authorities will become more difficult. Japan will share her savings with others at real-world interest rates, just as Americans and others shared their savings with Japan at real-world interest rates by means of loans floated in New York's financial markets.

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Such loans, of course, facilitated Japanese economic growth in the days when Japanese savings alone were insufficient to do the job.

It is quite clear, I believe, that the current state of formal liberalization of Japanese banking and investment controls has had only marginal effect in introducing an open capital market in Tokyo. Equally evident, I believe, is that the current mix of Japanese financial policies provides little or no impetus toward achieving a realistic value for Japan's currency. Quite the opposite.

Why should Japan abandon her successful currency stratgey? After all, the IMF does not require an open capital market. And no country has brought an IMF Article IV action against Japan charging that she has advantaged her trade at the expense of others by manipulating the yen's value.

The so-called surveillance provisions of the Article IV of the IMF are available for use. They are designed to help make certain that a floating exchange rate system is not abused. IMF members are enjoined to avoid manipulation of exchange rates:

"...to gain an unfair competitive advantage over other members."

Among the developments that might indicate the need for Article IV surveillance consultation is:

> "...behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements."

The United States Government is at liberty at any time to initiate Article IV consultations, and the IMF mechanism provides for an automatic annual review by the Fund's staff of Japan's economic policies as they affect Fund members.

I would repeat my question: Why should Japan abandon her successful strategy of maintaining an undervalued yen?

The answer is as straight-forward as the question. The world economic system requires the support of Japan at this critical time. Japan, which has benefited so much from the GATT-IMF international systems of liberal trade, finance, and investment, must protect her economic gains by a prudent policy of joining in the defense of these international arrangements which are being so sorely tried by world-wide inflation, recession, unemployment, and the worrisome unknowns of technological transformation.

Conclusion

My comments on the yen-dollar exchange rate are obviously very briefly stated. But only in viewing the yen as a seriously undervalued currency can one satisfactorily deal with the question of the dollar's strength. If the dollar is constantly viewed as over-valued, incorrect conclusions emerge respecting the steps necessary to deal effectively with inflation and resumption of growth in the United States. New investment in American industry, and the consequent improvement in American competitiveness, are made all the more difficult if loss of domestic markets and foreign markets as well is further accelerated by an unwarranted competitive advantage conferred on Japan by an undervalued yen.

In purely analytical terms, as U.S. interest rates drop, the dollar can remain strong if the outflow of interest rate-sensitive dollars is replaced by a material reduction of the global U.S. trade deficit. I think this is feasible, and represents sound U.S. national policy and responsible U.S. international economic policy.

APPENDIX

Articles of Agreement
of the
International Monetary Fund

Article IV
Obligations Regarding Exchange Arrangements

Section 1. *General obligations of members*

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. *General exchange arrangements*

(*a*) Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfillment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.

(*b*) Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

(*c*) To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

Section 3. *Surveillance over exchange arrangements*

(*a*) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(*b*) In order to fulfill its functions under (*a*) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Section 4. *Par values*

The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions of Schedule C apply.

Section 5. *Separate currencies within a member's territories*

(*a*) Action by a member with respect to its currency under this Article shall be deemed to apply to the separate currencies of all territories in respect of which the member has accepted this Agreement under Article XXX', Section 2(*g*) unless the member declares that its action relates either to the metropolitan currency alone, or only to one or more specified separate currencies, or to the metropolitan currency and one or more specified separate currencies.

(*b*) Action by the Fund under this Article shall be deemed to relate to all currencies of a member referred to in (*a*) above unless the Fund declares otherwise.

International Monetary Fund Executive Board Decision on Surveillance over Exchange Rate Policies, April 29, 1977

1. The Executive Board has discussed the implementation of Article IV of the proposed second amendment of the Articles of Agreement and has approved the attached document entitled *Surveillance over Exchange Rate Policies*. The Fund shall act in accordance with this document when the second amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled *Surveillance over Exchange Rate Policies* at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

General Principles

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance-of-payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: Recognizing . . . that a principal objective (of the international monetary system) is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

Principles for the Guidance of Members' Exchange Rate Policies

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized *inter alia* by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

Principles of Fund Surveillance over Exchange Rate Policies

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance-of-payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance-of-payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance-of-payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance-of-payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

Procedures for Surveillance

1. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

2. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually, and shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

3. Broad developments in exchange rates will be reviewed periodically by the Executive Board, *inter alia* in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

4. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

5. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

6. The Executive Directors shall review annually the general implementation of the Fund's surveillance over members' exchange rate policies.

from Floating Exchange Rates and International Monetary Reform
by Thomas D. Willett

APPENDIX

Articles of Agreement
of the
International Monetary Fund

Article IV
Obligations Regarding Exchange Arrangements

Section 1. *General obligations of members*

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. *General exchange arrangements*

(*a*) Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfillment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.

(*b*) Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

(*c*) To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

Section 3. *Surveillance over exchange arrangements*

(*a*) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(*b*) In order to fulfill its functions under (*a*) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Section 4. *Par values*

The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions of Schedule C apply.

Section 5. *Separate currencies within a member's territories*

(*a*) Action by a member with respect to its currency under this Article shall be deemed to apply to the separate currencies of all territories in respect of which the member has accepted this Agreement under Article XXX, Section 2(*g*) unless the member declares that its action relates either to the metropolitan currency alone, or only to one or more specified separate currencies, or to the metropolitan currency and one or more specified separate currencies.

(*b*) Action by the Fund under this Article shall be deemed to relate to all currencies of a member referred to in (*a*) above unless the Fund declares otherwise.

International Monetary Fund Executive Board Decision on Surveillance over Exchange Rate Policies, April 29, 1977

1. The Executive Board has discussed the implementation of Article IV of the proposed second amendment of the Articles of Agreement and has approved the attached document entitled *Surveillance over Exchange Rate Policies*. The Fund shall act in accordance with this document when the second amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled *Surveillance over Exchange Rate Policies* at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

General Principles

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance-of-payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: Recognizing . . . that a principal objective (of the international monetary system) is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

Principles for the Guidance of Members' Exchange Rate Policies

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized *inter alia* by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

Principles of Fund Surveillance over Exchange Rate Policies

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance-of-payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance-of-payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance-of-payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance-of-payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

Procedures for Surveillance

1. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

2. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually, and shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

3. Broad developments in exchange rates will be reviewed periodically by the Executive Board, *inter alia* in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

4. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

5. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

6. The Executive Directors shall review annually the general implementation of the Fund's surveillance over members' exchange rate policies.

from Floating Exchange Rates and International Monetary Reform
by Thomas D. Willett

Representative REUSS. Thank you, Mr. Fox.

Before calling on Mr. Branson, because I unfortunately am going to have to absent myself shortly, I would like to do two things: One, to commend the NAM for its position this morning and for many other positions it has recently taken before this committee. You are a big help to this committee and while I, as a liberal Democrat, don't necessarily subscribe to everything the NAM does, I want you and your associates to know that I find you thinking very constructively about our economic problems, both domestic and foreign.

Mr. Fox. Thank you very much.

Representative REUSS. I want to show that gratitude.

Second, and briefly, you, like Mr. Bergsten and Mr. Malmgren, have talked about the Japanese problem. Various solutions have been offered by all of you, designed in part to prevent the recurrence of protectionism in this country. I think that's a noble attempt on your part. There is one thing that the Japanese are doing which, it seems to me, is not defensible for a country which, by reason of the vagaries of the international monetary system, finds that it can sell its goods very cheaply abroad. It can sell those goods more cheaply than its comparative advantage would suggest, because the yen is so cheap in international markets. They really ought now, I suggest, to dismantle their system of export credits. There is no reason under the sun why they should add to the advantageous advantage they get out of a cheap yen by having, whether in MITI, in the Finance Ministry or wherever, the equivalent and more than the equivalent of an Export-Import Bank.

Mr. Fox. I very much agree with that, Mr. Chairman.

Representative REUSS. You didn't quite suggest it——

Mr. Fox. The subject has come up at the OECD sponsored discussions, to achieve agreements on export credits. Japan, now having the lowest interest rates of any of the industrialized countries continues to use its Export-Import Bank and exploit the advantage that their low interest rates give them. The recent purchase by New York City of, first, Japanese subway cars and then Canadian subway cars were both induced by the credit considerations and the lack of adequate competitive finance in the United States for domestic market credit.

In the case of Japan in the OECD, it has simply refused to consider that alternative of abandoning its Export-Import Bank, continues to use mixed credits with respect to developing finance, and as I've indicated, uses its low interest rates with Government mobilization of credit for exports to the United States, as in the case of the subway cars.

Representative REUSS. Let me then go backwards among the witnesses. No doubt Mr. Branson can get to this later. Mr. Malmgren?

Mr. MALMGREN. If I may, Mr. Chairman, comment on this thought of yours. I have followed this export credit debate for some time. I did suggest to the European Community, the United States, and Japan, about a year and a half ago, that one partial solution might be to get the permission of the Japanese Ministry of Finance to let Eximbank use yen or to guarantee loans in yen for exports to the United States to the other countries, for the British to do the same, because the yen would be much cheaper and the exchange risk is really not that important. Given the likely exchange risk, it would still mean lower interest rates. That has been agreed, then. That will be announced

very shortly. I think the Japanese had made a little breakthrough there, to ease the problem of financing Exim by using yen.

Representative REUSS. That's good. But it could be vitiated by their goosing the export credits in yen, which they themselves give.

Mr. MALMGREN. I agree, but there's another piece to this which is something—I've watched this MTA New York subway car episode. It seemed to me quite ridiculous that exports from Japan and Canada be financed by their governments to beat commercial bids in this country. It seems to me the original purpose of the Exim credit concept was to sell to countries that couldn't afford to buy without credit, namely, developing countries and the intermediate level countries, but now it's spilled over into the trade among the rich countries. It seems to me the undertakings in the OECD should rule out any official credits between the rich countries. In other words, we don't sell in Germany with credits and Germany doesn't sell here with credits. It's absolutely ridiculous to have subsidized trade among the rich countries. We don't need it and it makes a mockery of commercial bidding.

So that would be a big breakthrough, also. But nobody's trying to do that right now.

Representative REUSS. That's the trouble. That's been on the docket, but nothing happens.

Mr. MALMGREN. We have cases—not only the MTA subway thing, but recently 30 Caterpillar tractors turned up in Florida on a big project. It's my impression the headquarters of Caterpillar didn't even know they were sold because they came from Europe on the European government financing and beat out any domestic bid that was conceivable. That sort of thing is absolutely nonsense.

Representative REUSS. Would you agree, then, with my bumptious suggestion that it wouldn't be a bad idea if somebody in Ottawa mentioned that Congressmen like myself, who have stayed off U.S.-content bills, and Mr. Shultze's bill and others, cannot guarantee eternal purity unless the Japanese are going to knock it off on their Exim financing?

Mr. MALMGREN. I think, certainly, in regard to the trade with the more developed countries. It must be remembered that over half the Japanese trade is with developing countries. We think it all ends up here, but it doesn't. Most of it goes elsewhere, and for those countries, given the predicament——

Representative REUSS. I'll accept that.

Mr. MALMGREN. I certainly think they should and in terms of selling to the richer countries. I think it should be terminated, period.

Representative REUSS. Mr. Bergsten.

Mr. BERGSTEN. Mr. Chairman, at the analytical level, I couldn't agree with you or Hal more. I think the kind of changes you have suggested would help, but it is really the tail wagging the dog. I think, frankly, it is a little unrealistic.

Two years ago Japan was running a current account deficit of $18 billion. These things change very fast, and to ask Japan or the United States or any country which happens to be in big surplus at the moment to get rid of its export financing facilities, I think it is not going to be acceptable. However, what your point quite rightly does is reiterate the absurdity of two things: The current exchange rate situation, and therefore if properly used, I would think it could add to the willingness of the Japanese to take the kinds of measures I've suggested or

others have suggested and get the yen up to the 180–200 range in the next 6 months; and second, it shows the absurdity of a whole international export credit system where all countries are extending credits in their own currencies at their own national interest rates, whether or not those bear any relationship to the underlying competitive situation.

If we're going to have an export credit system, all countries ought to extend their export credits and its SDR's at the SDR interest rate, and that would take this crazy competition to a much lower level.

Representative REUSS. I agree that the arms race in export credits is as silly as the arms race in arms. Nothing much seems to be done about it. With Japan, we are faced with a stubborn, immediate fact that all hell is going to break loose in this country, and in the world, unless something is done about the level of Japanese exports—in our case to the United States. That's what we've got to look at first. And this export credit spigot is turnable, on or off, and I don't see why we don't say turn it off until either the deficit situation changes or until further notice.

Mr. BERGSTEN. Mr. Chairman, you have noticed in my testimony I proposed a complete moratorium on capital outflows by Japanese residents. One could include right in that outflows of trade credits, and that would, in fact, kill two birds with one stone.

Representatives REUSS. I have a little problem, though. I have no objection whatsoever to Japanese credits to set up factories in Wisconsin. I like them, I solicit them. I would immolate myself for them. [Laughter.]

But what I don't want is Japanese export credits. So I think we should be surgical about this.

I didn't mean to digress too long. So let's hear from Mr. Branson. I'm going to ask Congressman Richmond to take over until I am able to get back.

Representative RICHMOND [presiding]. Thank you.

Mr. Branson.

STATEMENT OF WILLIAM H. BRANSON, PROFESSOR, WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY, PRINCETON, N.J., AND ASSOCIATED WITH THE NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MASS.

Mr. BRANSON. Thank you, Congressman. It's a pleasure and a privilege to come and testify at the hearings before the Versailles summit.

I would like to begin by separating macroeconomic and monetary problems from questions of underlying structure of U.S. trade; that's because I think while the current macroeconomic situation is dismal and getting worse, the underlying structural adjustment that the U.S. economy has gone through in the 1970's I think has been rather more successful than people in Washington or in general in the country understand.

I certainly agree with the previous witnesses that U.S. interest rates are too high. The reason seems to me to be because the projected deficits, not this fiscal year but into the future, are so large. The financial markets can see that if the Federal deficit is going to run 5 percent of GNP 3 years from now, the Federal Reserve is going to have to tighten on monetary policy enough to reduce investment in the United

States to be 5 percent less than saving is a fraction of GNP, in order to make room for that deficit, and the markets are anticipating that kind of tightness in the long term interest rates.

The consequence of this, of course, is that the dollar is very strong, probably overvalued, and U.S. budget policy seems to me to be the basic problem. Europeans, though, have, I think, separate problems that wouldn't go away just if the U.S. fiscal and monetary mix were adjusted. I think Mr. Malmgren noted that the Europeans are in for a long period of difficulty and structural adjustment, and they have not shown themselves to be very good at it in the past decade.

EXCHANGE RATE REALIGNMENT MAY NOT BE ANSWER

Now, I'm not as positive as the other witnesses here that exchange rate realignment would be the key to straightening out the Japanese trade balance problem. It was noted by the previous speaker that there is a very high export to import ratio of manufacturers in Japanese trade. I think Japanese imports are approximately 85 to 90 percent raw materials. Their exports are approximately 75 percent manufactured goods. Basically, what Japan is doing in its trade is importing raw materials, transforming it into final output and exporting it.

Now, given that trade structure, a change in the exchange rate will not, for instance, induce substitution between imports and domestic output because they're not producing domestically what they import. So one major channel of adjustment is cut off, due to the structure of trade.

I think in this discussion we should remember that the current account balance of any country is the excess of national saving over investment and the Japanese are, in terms of international comparisons, high savers. And I'm not sure that exchange rate adjustment would be the key to altering that situation. That makes it difficult to see exactly what should be done in that situation, even if the Japanese were to agree that their excess of saving over investment is excessive.

You could argue that they should stimulate investment in order to reduce that balance, but stimulating investment would mean easier monetary policy and even more depreciation of the yen. So I am not as confident as some of the others here that the yen exchange rate is the central part of that problem. I think that looking at the balance between saving and investment and asking should Japan be punished for being an international saver should be kept in mind.

CHANGING STRUCTURE OF U.S. TRADE

Let me turn to the changing structure of U.S. trade and the adjustment that's gone on since the early 1970's.

I think that since the early 1970's we have seen a major reorientation of the U.S. economy toward producing and exporting capital goods and importing consumer goods. And basically, as Mr. Malmgren was saying, we should identify winners as well as losers.

The U.S. economy is not one big steel company about to go under. The U.S. economy has a very strong position in world trade and capital goods. In 1980, the United States had an export surplus of approximately $45 to $50 billion in its trade and capital goods.

Now, one of the key features of the expanding exports of capital goods is that it is going—the expansion is going mainly to the developing countries, not to the other industrial countries. In the period from 1973 to 1980, U.S. real GNP grew at about 2.4 percent a year. U.S. real exports of capital goods total grew at 11.2 percent per year in that same period. U.S. exports of capital goods to Latin America grew at approximately 14 percent a year; to South Asia, 21 percent a year; to Southeast Asia, 16½ percent a year.

So, the picture that we get, looking at the trade and capital goods, is total exports growing much faster than the U.S. economy and exports to the developing countries growing much faster than the total. A consequence of this has been that, while capital goods exports—of capital goods exports, 30 percent went to the developing countries in 1970. About 42 percent go to the developing countries now. The other side of that point has been growth in U.S. imports of nonauto, nonfood consumer goods; in other words, manufactured consumer goods, from the developing countries——

Mr. RICHMOND. I call them beads and whiskey.

Mr. BRANSON. OK. [Laughter.]

Again, in 1972 to 1980, while the U.S. economy was growing 2 to 4 percent a year, imports of consumer goods grew at about 6 percent, and imports from those same countries that were taking our capital goods exports grew faster than 6 percent.

And, in addition, the developing countries now provide 50 percent of our imports of these goods; whereas, 10 years ago it was 25 percent. There is still, if we look at the capital goods, consumer goods trade with the developing countries, a large surplus on the U.S. side, but we see increasingly a kind of structural change in which we export capital goods, import consumer goods from the developing countries.

Now, there are several points, I think, that follow from this. One is that there has been a structural adjustment in the U.S. economy that goes largely unrecognized because the capital goods manufacturers do not have the identity of a steel industry or an auto industry and they don't—therefore can't speak with the same firmness of voice. But there has been a reallocation of resources in the economy that has put the United States in a relatively better position than Europe certainly.

EUROPEAN TRADE STRUCTURE STABLE

This kind of reallocation has not been happening in Europe. If you talk to European economists about trade projections, they see no change in the structure of their trade in the 1970's. They don't project any in the 1980's. And the result of this is strong resistance in Europe to imports from the developing countries and a tendency to be more protectionist and more rigid.

DEVELOPING COMPLEMENTARITY BETWEEN THE UNITED STATES AND DEVELOPING COUNTRIES

A second implication, I think, is that there is a concentration of interest between the United States and the developing countries that has gone largely unrecognized. There is a complementarity that is being developed, and its growth in the developing countries, both the

newly industrializing countries of the 1970's and the new newly industrialized countries that might appear in the 1980's, is in the U.S. interest. That is where our markets are.

The European market is not going to grow. The developing countries are where U.S. exports are going to be going in the 1980's. This implies, I think, that in U.S. foreign economic policy more emphasis should be placed on developing relationships with the developing countries. If we combine the restructuring of U.S. trade with the likely stagnation in Europe, one can even see the outline of a possible major change in the balance of U.S. economic interest moving away from close ties to the Europeans and towards closer ties with the newly industrializing countries.

So, I think that while the current economic situation is bad and getting worse, the underlying structural adjustment that has been happening in the U.S. economy has been pretty good. We have absorbed a $76 billion oil deficit by generating a $25 billion agricultural surplus and a $40 billion capital goods surplus. That says that in terms of flexibility and reallocation of resources the U.S. economy is in much better shape than certainly the European economies.

Thank you, sir.

[The prepared statement of Mr. Branson follows:]

PREPARED STATEMENT OF WILLIAM H. BRANSON

The OPEC Surplus and US-LDC Trade

I. Introduction and Summary

This paper explores the connections between the shift of world saving toward OPEC and the changing structure of U.S. trade with the non-oil developing countries. The basic point of the paper is that during the 1970's, the U.S. economy has become more interdependent through trade with the newly industrializing countries (NICs) in the developing world. U.S. exports of capital goods to these countries have grown rapidly, as have U.S. imports of non-food, non-auto consumer goods. Thus the structure of U.S. trade has been reoriented to become complementary with the rapidly-growing developing countries. Formulation of U.S. foreign economic policy should be sensitive to this change.

The basic facts are presented in tables in the paper. Tables 1 and 2 show the growth of the developing countries in the 1970's, which was not slowed appreciably by the OECD recession. Table 5 shows the high level of investment and rapid growth of the NICs, in particular. The extent of borrowing by these countries is well-known, and the numbers are shown in Tables 3 and 4. Essentially, the NICs borrowed the OPEC surplus, invested, and grew. The changing structure of U.S. trade is shown in Tables 6 through 10. In Table 6 we see the shift of U.S. trade toward surpluses in capital goods and agriculture that approximately finance the deficit on energy. In Tables 7 and 8 the growth of U.S. exports of capital goods to the developing countries is shown. From 1975-1980 these grew at an annual rate of 11.2 percent in real terms. In 1970, 30 percent of U.S. capital goods exports went to the developing countries; by 1980 the fraction was 42 percent. In Tables 9 and 10 we see a similar development of U.S. imports of

non-food, non-auto consumer goods.

The paper interprets these changes as follows. The shift of world saving toward OPEC effectively internationalized the supply of saving, as OPEC places its surplus in the international financial system. The NICs and other developing countries borrow the surplus and direct it to domestic investment. Investment in the NICs stimulates the demand for U.S. capital goods. The reallocation of resources towards capital goods production in the U.S. stimulates excess demand for consumer goods, which appear as imports. Thus the resource shifts as the U.S. make its economy more complementary to the developing countries, and perhaps more competitive with Europe and Japan.

The structure of the paper is as follows. In section II we briefly review models of interdependence, and argue that the channel that allocates world saving to local investment is increasing in importance. In section III we show the pattern of borrowing, investment, and growth in developing countries. Then in section IV we discuss the changing structure of U.S. trade. The numbers give the impression of an economy in the process of resource reallocation toward its comparative advantage in a world of interaction between financial flows and trade.

II. Models of Macroeconomic Interdependence

A basic argument of this paper is that the rise of OPEC as a supplier of world saving has made growth in developing countries less dependent on the OECD countries. In this section we will sketch the basic theoretical framework for studying interdependence between the OECD (and U.S.) and the developing countries (DCs). We will focus here on "macro-level" interdependence, to draw a distinction with "structural interdependence" between the U.S. and the DCs, which is discussed below in section IV.

By interdependence at the macro level we mean interdependence of aggregate variables such as GNP or the price level between countries or regions. At this level, interdependence can work through many channels. Movements in demand in one country can spill over into demand for another's exports, and this in turn can feed back into the country originating the disturbance. There are in the economics literature models with various levels of complexity that focus on trade as a channel of interdependence. Examples are found in Robinson (1952) and Branson-Rotemberg (1980). We will call these "demand side" links.

Another family of economic models focuses on the world allocation of saving and investment through international capital markets. In the extreme version of this model, with "perfect" capital mobility, all saving flows into a world pool, and is then allocated to national investment according to relative expected real rates of return. In this model an increase in saving in the U.S. would show up as an increase in investment in the developing countries, but increased investment in the U.S. would draw capital away from the developing countries. We will call this the "supply-side" link; a good recent paper giving a sophisticated version

is Lipton-Sachs (1980). The rise of OPEC as a world investor with capital seeking a high and safe return has increased the relevance of this model in the 1970s.

A. Demand-side Links

To illustrate the variety and complexity of interdependence through demand-side links, we will summarize three fairly simple models that analyze interactions between two countries. The first is a one-commodity purchasing-power-parity model, taken from Branson-Rotemberg (1980). The second is the two-commodity fixed-price model of Robinson (1952). The last is the two-commodity model with flexible prices of Branson-Rotemberg (1980). Even in this overly simplified model the complexities are apparent: it is quite possible that an increase in demand in one area reduces putput in the other!

1. One commodity with rigid wages

We begin by describing the simplest macro model that yields interesting results for the effects of demand policy. We will just outline the argument and summarize a results here. Technical details are presented in Branson-Rotemberg (1980).

Think of a world of two countries, each producing the same good (the "schmoo"). Trade is free, so if the price of the good in the "foreign" country is P^*, the price the "home" country must be $P = eP^*$. The exchange rate e simply translates the foreign price into the home price. Suppose in the foreign country -- Western Europe is a good example -- real wages are fixed by indexation. But in the home country money wages

are fixed by custom or contract in the short run. Finally, let us make the standard assumption that employers will expand output and employment if their output price rises relative to the wage rate.

Consider now what happens if demand is expanded, by monetary or fiscal policy in Western Europe. This pulls up wages and prices there, with no effect on output or employment, demand expansion is purely inflationary. But what happens in the United States? The expansion in demand in Western Europe spills over into demand for U.S. exports. As U.S. prices rise relative to wage rates, output and employment rise. Thus this demand stimulus in Western Europe is purely inflationary there. It reduces the European trade surplus and the U.S. trade deficit. Finally, the expansion in Europe increases output and employment in the U.S. It is easy to see why the U.S. argued for demand stimulus in Europe in 1976 and the Europeans resisted.

If, however, money wages were sticky in Europe as well as the U.S., the result would be different. The demand stimulus in Europe would raise prices, output, and employment in both Europe and the U.S. The European trade surplus and the U.S. deficit would be reduced. This is the model the U.S. side of the 1976-78 discussion probably had in mind. Branson-Rotemberg (1980) argue that it is not appropriate for most of Europe, and Japan, where real wage rates tend to be more sticky.

What is the effect of growth in the developing countries in this model? If growth rates increast autonomously in the developing world (due, perhaps, to an improvement in policy or efficiency), demand for the

exports of both the U.S. and Europe will increase. In Europe, with real wage rigidity, this will increase the trade surplus and inflation, but not employment or output. In the U.S., with sticky money wages, employment and output will rise, as well.

2. Two commodities with rigid prices

Another model giving the same general and clear-cut result that a demand expansion in one country raises output in the others through the trade channel is the two-country multiplier model of Romney Robinson (1952). In Robinson's framework, each country produces a different good, or bundle of goods, but movements of relative prices are suppressed in the analysis, to focus on the Keynesian demand-side multiplier mechanism.

In the Robinson model, each country's imports from the other depends on its own level of output (and income). Each country's exports are the other's imports. What is the effect of a policy-induced demand expansion in this model? Suppose demand is stimulated by fiscal or monetary policy in Europe. This increases income in Europe by a Keynesian multiplier mechanism. This raises European imports from the U.S. Income rises in the U.S. via a Keynesian multiplier. This, in turn, raises imports from Europe, starting a second round of multiplier effects.

The Robinson repercussion model is illustrated in Figure 1. U.S. income y is given on the vertical axis, and European income y^* on the horizontal axis. The $y(y^*)$ line shows the dependence of U.S. income on Europe, and the $y^*(y)$ line shows the dependence of European income on the U.S. Equilibrium income in both countries is at the intersection of the two curves.

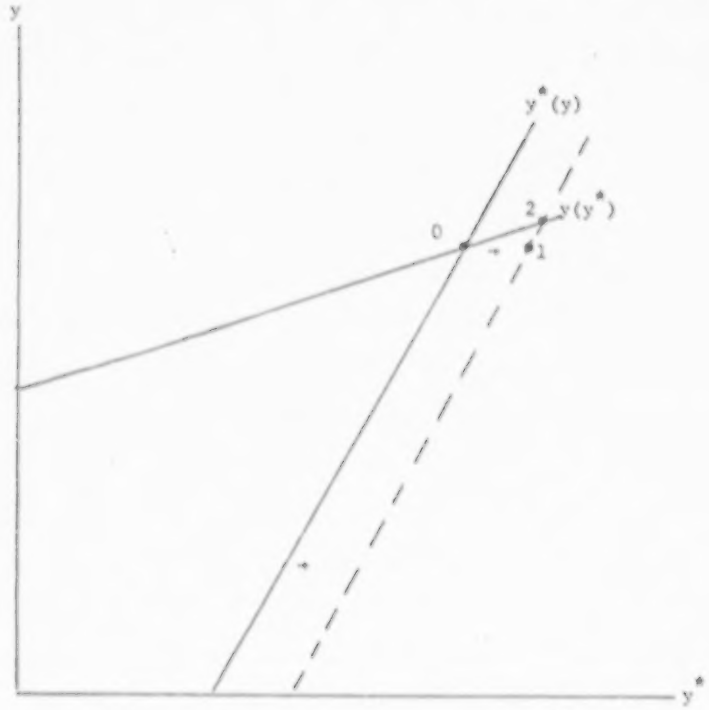

Figure 1: Foreign Trade Multipliers

Fiscal expansion in Europe is illustrated by the outward shift in $y^*(y)$. The movement in European income from point zero to point 1 is the Keynesian expansion without feedback from the U.S. The movement from point 1 to point 2 in the additional international trade multiplier. This provides expansion in U.S. income, and a further increase in European income. Clearly the more sensitive each country's income is to movements on the other, the greater will be the addition to the multiplier.

An increase in the exchange rate e, defined as units of home-currency (y) per unit of foreign currency (y^*)--a devaluation of y's currency--will shift the $y(y^*)$ function up and the $y^*(y)$ function left. The devaluation of a y's currency shifts would demand toward y output and away from y^*. This moves the equilibrium in Figure 1 up and to the left, raising y and reducing y^*. This is a stark example of a "beggar-thy-neighbor" devaluation in y.

The Robinson repercussions model is the basis for most thinking about the demand-side link through trade. At its beginning, Project Link was a many-country version of the Robinson model, for example. However, even it is more complicated than necessary. If prices are to be held constant, there is not much point in introducing two goods, and one can think just as well in terms of the one-commodity model in section A-1. If one wants to

introduce two goods, then relative price changes should also be considered. When the possibility is allowed, the situation changes substantially, however.

3. Two commodities, flexible prices

The Robinson model yields clear-cut results for interdependence by assuming fixed prices. In that case the international trade feedbacks add to the standard Keynesian multipliers. However, the assumption of fixed prices is crucial. In the last half-dozen years, several papers have noted that with prices adjusting, the cross-country multipliers can become negative: a demand expansion in one country can lead to a contraction of output in another. Branson-Rotemberg (1950) argue that this may be an important element in the relations between the U.S. and the rest of the major OECD countries (Europe and Japan).

We can see how this possibility arises just by studying labor supply and demand in one country. Consider a situation in which each of two countries specializes in production of one good, and they trade. The relevant price level for producers on the demand side of the labor market is the price of the home good P. However, workers consume both goods, the home good with price P, and the import with price P*. The relevant price level for labor supply decisions is the CPI, which is weighted average of P and P*. Thus the demand for labor depends on P,; as P rises the demand for labor increases. The supply of labor is responsive to both P and P*. When either rises, the supply curve shifts up as workers demand higher wages. Equilibrium employment in this situation is shown no N_0 in Figure 2.

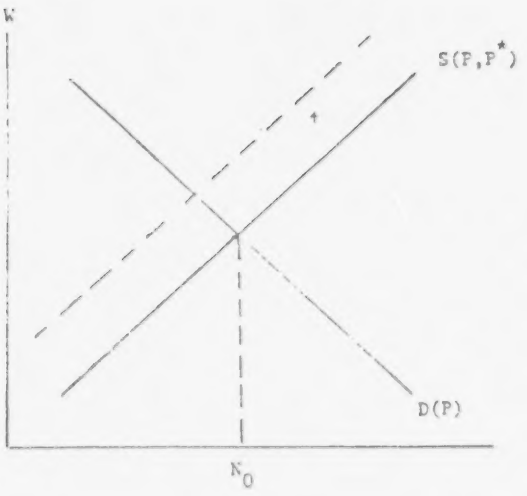

Figure 2: Labor Market Equilibrium and the Terms of Trade

Now consider what happens when demand rises abroad, pulling up P^*. This increases the CPI, and reduces the real wage labor receives. This "terms of trade effect" shifts the labor supply function in Figure 2 up, reducing employment and output at home. Thus it is possible that the demand expansion in one country reduces output in the other through the terms-of-trade effect. This theoretical possibility was noted by Argy and Salop (1979) and Sachs (1979), and Branson-Rotemberg (1980) argue that it may be a reasonable characterization of reaction in Western Europe and Japan to expansion in the U.S.

The relevance of these results for interdependence between the U.S. and developing countries results from consideration of the US-Europe-Japan relationship. Assume for a moment that most developing countries and the U.S. have sticky money wages, but that Europe and Japan follow the model of Figure 2. Then an expansion of demand in the U.S. could reduce output in Europe and Japan. The total effect on demand for the output of the developing countries would be unclear; it would depend on the weights of the U.S. vs Europe and Japan on their exports. Similarly, the effect of an expansion in demand in the developing countries on the U.S. would be unclear. The contractionary result in Europe could outweigh the expansionary effect from the developing countries.

These complexities and ambiguities arise in the simplest of models when we consider carefully supply-side effects. Their empirical importance and relevance for policy are not clear now; research in this area is only beginning.[/] But at least this tells us to beware of reliance on simple demand-side multiplier models of trade interaction.

[/] It is a principal focus of the research program in Comparative Macroeconomics within the Program in International Studies at the National Bureau of Economic Research.

B. Supply-side or Financial Market Links

The second major channel of macro-level interdependence between the U.S. and the developing countries is through the international allocation of world saving to national investment. I will call this the "supply-side" link. Since saving is allocated to investment needs through international financial markets, we could also call this the "financial" or "saving-investment" channel.

Whatever we name it, this is the international financial mechanism that allocates world saving to domestic investment. The rise of OPEC as a world saver providing its surplus to the financial markets has probably increased the importance of this channel in the 1970s, and may make its implications crucial for the 1980s and beyond.

The basic mechanism is simple. Consider the extreme case of "perfect" capital mobility with no artificial barriers to international capital movements. In this case world saving would flow into one central pool--the international capital market--and then be allocated to investment in national economies according to differential real returns and risks. The amount of investment any given country could draw from the pool would depend on its real rate of return. If a major country such as the U.S. significantly increased its demand on the saving pool, it would probably reduce the flow to the developing countries. On the other hand, if it increased saving it would increase the flow to the developing countries. Let us briefly examine how this international saving-investment link works to influence investment and growth in the U.S. and in the developing countries, using a few examples of potentially relevant events.

(a) Increase in U.S. saving.

A policy that increases the U.S. saving ratio would increase the world saving pool, and increase investment in developing countries and in the U.S. by their marginal shares of the pool.

(b) Increase in U.S. investment.

An increase in U.S. investment could be achieved by increasing the U.S. real rate of return, perhaps through tax incentives. Through the world saving-investment channel, this would increase investment in the U.S. and reduce investment in the developing countries, holding world saving constant. Of course, through the demand-side links this might be offset by an expansion of income and saving in the U.S., which could also offset the effect through the saving-investment channel, but only partially.

(c) Increase in developing country productivity.

This is the effect studied in detail by Lipton-Sachs (1980) in their more sophisticated model of the world saving-investment mechanism. An increase in the real rate of return in developing countries will shift the allocation of saving toward investment in the developing countries, and away from investment in the U.S.

(d) Shift in world distribution of income.

The increase in the real price of oil shifted the world distribution of income from the U.S. and developing countries and toward the oil-exporters. If we assume that the latter's

saving rate exceeds those of the importers, which seems to be the case, this will increase the world saving rate. Investment in the developing countries will then rise by their marginal share of the world saving pool. This seems to have been an important effect in the 1970s, as developing countries maintained investment and growth rates by borrowing in the euromarkets while the OECD world went into stagnation. We will review this evidence more thoroughly in Section III below.

In addition to the simple effect of an increase in world saving, the shift of the locus of saving toward OPEC probably increased the importance of the supply-side link by increasing the international mobility of capital. The OPEC surplus tends to go to the Euromarkets which are major suppliers of funds to the developing countries. In a sense, the shift toward OPEC has increased the degree to which saving and investment are internationalized. This has weakened the dependence of developing countries on bilateral links and OECD growth.

Each of the examples (a) - (d) discussed the effect of a single shift in saving or investment. One could combine these to analyze the effects of simultaneous shifts. In general, the results of combinations of events in one area for growth in other areas of the world will depend on the originating area's net draw on the world saving pool. If a change in tax policy in the U.S. increases saving and investment, U.S. growth will increase. If saving rises more than investment, the world saving

pool will increase, on balance, and investment will rise in the developing countries. If an increase in efficiency in the developing countries raises their saving and investment, their growth rates will rise. The result for U.S. investment and growth will depend on whether saving increased more than investment in the developing countries. Thus an event can, in general, benefit all if it raises saving more than investment locally, adding to the world saving pool on balance.

III. Empirical Evidence from the 1970s

The demand-side model of section II-A would lead us to expect that growth in GNP in developing countries would be closely tied to growth in the industrial countries. The supply-side model of section II-B would shift the focus of interdependence toward the international capital markets. It would suggest more independence of developing country growth rates from those of industrial countries, and more dependence in international saving flows. Here we review the evidence from the 1970s, and conclude that a shift toward thinking along the lines of the supply-side model is appropriate for the 1980s.

A. Real Growth Rates and Terms of Trade

Table 1 presents a summary of global growth rates for the period 1950-77. In the data on GNP per capita, we see industrialized countries' growth rising from 2.5 percent per year in the decade 1950-60 to 4 percent in 1960-70, and then falling back to 2.4 percent in 1970-77. The low-income developing countries follow a roughly similar pattern, although their pattern within the 1960-70 decade was quite different from that of the industrialized countries. It is interesting to note that the 1950-60 and 1970-77 relation between the growth rates of these two areas rates is identical.

TABLE 1: GLOBAL GROWTH RATES, 1950-1977

INCOME GROUP/REGION/COUNTRY	POPULATION				GROSS DOMESTIC PRODUCT				GDP PER CAPITA			
	1950-60	1960-65	1965-70	1970-77	1950-60	1960-65	1965-70	1970-77	1950-60	1960-65	1965-70	1970-77
DEVELOPING COUNTRIES	2.2	2.4	2.5	2.4	4.9	5.6	6.4	5.7	2.7	3.1	3.8	3.2
CAPITAL-SURPLUS OIL-EXPORTING COUNTRIES	2.3	3.2	3.7	4.1	--	--	11.0	6.7	--	--	7.2	3.0
INDUSTRIALIZED COUNTRIES	1.2	1.2	0.9	0.8	3.8	5.3	4.9	3.2	2.5	4.0	4.0	2.4
CENTRALLY PLANNED ECONOMIES	1.7	1.8	1.6	1.4	--	6.2	7.7	6.4	--	4.8	6.7	5.6
A. DEVELOPING COUNTRIES BY INCOME GROUP												
LOW INCOME	2.0	2.4	2.4	2.2	3.8	3.8	5.3	4.0	1.8	1.4	2.8	1.7
MIDDLE INCOME	2.4	2.5	2.5	2.5	5.3	6.1	6.6	6.0	2.8	3.5	4.0	3.4
B. DEVELOPING COUNTRIES BY REGION												
AFRICA SOUTH OF SAHARA	2.3	2.5	2.5	2.7	3.6	5.0	4.9	3.7	1.3	2.4	2.3	0.9
MIDDLE EAST AND NORTH AFRICA	2.4	2.6	2.7	2.7	5.1	6.4	9.4	7.1	2.6	3.7	6.5	4.3
EAST ASIA AND PACIFIC	2.4	2.6	2.5	2.2	5.2	5.5	8.0	8.0	2.8	2.8	5.4	5.7
SOUTH ASIA	1.9	2.4	2.4	2.2	3.8	4.3	4.9	3.2	1.8	1.9	2.4	1.0
LATIN AMERICA AND THE CARIBBEAN	2.8	2.8	2.7	2.7	5.3	5.2	6.1	6.2	2.6	2.3	3.3	3.4
SOUTHERN EUROPE	1.5	1.4	1.4	1.5	6.1	7.5	6.5	5.3	4.5	6.0	5.0	3.8

SOURCE: World Tables, 1980.

The middle-income developing countries exhibit a quite different pattern, however. Their per capita growth rate rose from 2.8 percent in the 1950s to 3.5 and 4.0 percent in the first and second halves of the 1960s, respectively. It then fell to 3.4 percent in 1970-77. Thus in the 1950s the middle-income countries grew at a 2.8 percent rate when the industrial countries grew at 2.5 percent. However, in the 1970s, the middle-income countries grew at 3.4 percent with an industrial country growth rate of 2.4 percent.

In the breakdown in the bottom half of Table 1, we see that the slowdown in the 1970s in the industrial countries was followed in Africa, South Asia, and Southern Europe, but not in East Asia or Latin America. This is consistent with the middle-income vs. low-income experience.

More detail on growth of real GNP is given in Table 2. There we see that the 1974-75 recession in the industrial countries was followed by the African countries, and perhaps with a year's lag in Latin America. Oil-importing developing countries, as a group, show a mild growth slowdown in 1974-75, in contrast to the industrial country recession. Low-income countries experienced the slowdown in 1974, and manufactures importers in 1975. But in general, the data show much more stable growth in real output in the oil-importing developing countries than in the industrial countries in the 1970s.

At the bottom of Table 2, we show fluctuations in the terms of trade in the industrial countries, OPEC, and non-oil developing countries. In 1974 we see the jump on the OPEC terms of trade, reflected in a drop in the other two areas. The recession of 1975 in

the industrial countries raised their terms of trade by 2.5 percent, at the expense of OPEC and the non-oil developing countries. The recovery of 1976-77 in the industrial countries reduced their terms of trade, to the benefit of the other two. In every year from 1975 to 1978 the non-oil developing countries' terms of trade moved in the opposite direction to the industrial countries!

The data of Tables 1 and 2 suggest the following generalizations.

(a) In the 1970s, fluctuations in output in the industrial countries caused similar fluctuations in non-oil developing countries' terms of trade.

(b) Fluctuations in real output in the non-oil developing countries were much smaller than those in the industrial countries.

(c) The middle-income developing countries seemed less sensitive to output fluctuations in the industrial countries than were the low-income countries.

These generalizations imply that in the 1970s middle-income developing countries were able to stabilize output growth relative to industrial countries' fluctuations, which showed up in movements in the terms of trade. This would be consistent with the supply-side model. However, the behavior of the low-income countries seems relatively more consistent with the demand-side model.

TABLE 2: Growth of Real GNP and Terms of Trade

	Avg. to 1972	Change from Preceding Year							
		1973	1974	1975	1976	1977	1978	1979	1980
Real GNP									
Industrial Countries	4.8[a]	6.3	0.7	-0.6	5.2	3.9	4.0	3.7	1.2
Non-Oil Developing Countries									
Areas									
Africa	5.0[b]	3.6	6.9	1.9	4.2	1.4	2.2	3.2	4.9
Asia	4.6[b]	5.4	4.0	6.1	6.4	6.4	8.3	3.3	3.5
Middle East	7.4[b]	5.1	3.2	4.8	3.7	5.8	8.0	6.3	5.1
Western Hemisphere	7.2[b]	8.3	7.2	2.8	4.6	4.4	4.6	6.5	5.8
Groups									
Oil Exporters	6.0[b]	7.5	6.1	5.3	4.8	3.2	5.8	7.1	6.7
Oil Importers[c]	5.8[b]	6.0	5.5	3.7	5.5	5.1	5.5	4.5	4.0
Manufactures Exporters	8.1[b]	9.6	6.6	3.4	6.1	5.1	5.2	6.5	4.7
Low-income[c]	3.4[b]	2.9	3.2	5.7	3.4	4.7	6.0	0.2	3.1
Other	5.5[b]	4.1	6.0	2.6	6.4	5.4	5.6	4.1	3.4
Terms of Trade									
Industrial Countries	0.2[a]	-1.7	-11.7	2.1	-0.8	-1.2	2.8	-3.1	-6.7
Oil Exporters	0.5[a]	13.4	138.3	-5.4	5.6	0.6	-10.8	27.8	41.8
Non-Oil Developing Countries	-0.3[a]	6.5	-6.9	-8.9	2.2	6.3	-5.6	-0.5	-3.1

Notes:
a. Compound annual rate of change, 1962-72
b. Compound annual rate of change, 1967-72
c. Excludes China.

Source: IMF Annual Report, 1981, Tables 1, 2, 5.

B. External Borrowing

The data on external borrowing by developing countries in the 1970s support this conclusion. Over the period since 1973, the cumulative deficit of the DCs has approximately equalled the cumulative surplus of OPEC. The data are shown in Table 3, borrowed from Colin Bradford (1981). The cumulative OPEC surplus is $453.8 billion, and the cumulative DC deficit is $415.9 billion. Thus in effect, the developing countries borrowed the OPEC surplus.

Details for borrowing by the newly industrializing countries (NICs) among the developing countries (DC-NICs), and a group of countries identified by Bradford (1981) as "next tier" NICs are shown in Table 4. There we show external public debt in billions of dollars and as a percent of GNP, and the debt-service ratio, in 1970 and 1978 (end of year) for low-income and middle income countries.

Among the 38 countries listed by the World Bank as "low-income," India, Pakistan, and Indonesia were by far the major international debtors in 1979. Their total of $37 billion in 1978 was about 63% of the aggregate $57 billion for low-income countries; the next largest low-income debtor in 1979 was Zaire, with $3.8 billion.

In 1970, India, Pakistan, and Indonesia together owed $13.4 billion out of an aggregate of approximately $17 billion for the low-income countries. Thus during the 1970s, among the low-income countries the debt of these "big three" increased from $13.4 to $37 billion; the debt of the rest of the 38 countries increased from about $3.6 billion to $19 billion. While India, Pakistan, and Indonesia remained the major borrowers, international debt finance showed a significant increase among the rest of the low-income group.

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TABLE 3: Summary of Current Account Balances: 1973-1981
(In Billions of U.S. Dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	TOTAL 1974-1981
OPEC	6.6	67.8	35.0	40.0	31.1	3.3	68.4	112.2	96.0	453.8
NON-OIL LDCs	-11.5	-36.8	-46.5	-32.9	-29.6	-37.1	-56.1	- 80.4	-96.5	-415.9
LDC/OPEC		(54.3%)	(132.9%)	(82.3%)	(95.2%)	--	(82.0%)	(71.7%)	(100%)	91.6%
INDUSTRIAL COUNTRIES	19.3	-12.4	17.1	- 2.1	- 5.5	30.1	-10.7	- 44.0	-29.5	
IC/OPEC		(18.3%)	--	(5.3%)	(17.9%)	--	(15.6%)	(39.2%)	(30.7%)	

Source: International Monetary Fund, World Economic Outlook, Occasional Paper No. 4, Washington, D. C., June, 1981, Table 14, p. 123.

TABLE 4: EXTERNAL PUBLIC DEBT AND DEBT SERVICE RATIOS

Country or Group	External Public Debt $ billion 1970	External Public Debt $ billion 1979	External Public Debt % of GNP 1970	External Public Debt % of GNP 1979	Debt Service Ratio [a] 1970	Debt Service Ratio [a] 1978
DC-NICs						
Low-income						
India	7.9	15.6	14.8	12.3	20.9	9.5
Middle-Income						
S. Korea	1.8	14.7	20.9	24.5	19.4	13.5
Taiwan [b]	0.6	2.9	10.6	12.1	4.5	4.4
Hong Kong	0.0	0.4	0.1	2.2	0.0	0.0
Singapore	0.2	1.3	7.9	14.8	0.6	1.3
Brazil	3.2	35.1	7.2	17.7	12.4	34.6
Argentina	1.7	8.7	7.6	8.6	21.5	15.5
Mexico	3.2	28.8	9.7	24.5	24.1	64.1
NEXT TIER						
Low-income						
Indonesia	2.4	13.3	27.1	28.3	6.9	13.4
Pakistan	3.1	8.0	30.5	38.5	23.6	12.0
Middle-income						
Malaysia	0.4	3.0	10.0	15.4	3.6	4.7
Philippines	0.6	5.2	9.2	17.3	7.5	12.6
Thailand	0.3	2.7	4.9	9.9	3.3	4.2
Columbia	1.2	3.4	18.1	12.6	11.6	12.5

Notes:

a. Ratio of debt service to exports of goods and services

b. Data for Taiwan are for 1970 and 1978, since Taiwan does not appear in the 1981 World Development Report

Source: World Development Report, 1981

The really major borrowers in the 1970s were, however, the 52 countries listed by the World Bank as "middle-income." Their total external public debt was approximately $250 billion at the end of 1979. These countries all show major debt expansion in the 1970s as they borrowed to finance investment and growth.

C. Investment and Growth

The data on investment and real GDP growth in the NICs and record-tier NICs, are summarized in Table 5. We show growth rates of real GDP and gross domestic investment for the decades 1960-70 and 1970-79.-/ Investment as a percentage of GDP is shown in the last two columns for 1960 and 1979.

In more than half the countries in Table 5, the growth rates of real GDP and real investment rose in the 1970s relative to the 1960s. In almost all cases, the growth rate of investment was larger than that of GDP in the 1970s. And in all cases the investment - GDP ratio was larger in 1979 than in 1960, usually showing a big increase.

The data thus show a substantial rise in investment in the NICs and next-tier countries in Table 5, financed by the increase in borrowing shown in Table 4. These countries borrowed the OPEC surplus and invested it. The result was a maintenance or increase in growth in the 1970s in the face of the OECD slowdown.

-/Note that Taiwan is not in Table 5 since it no longer appears in World Development Report tables.

TABLE 5: Growth of GDP and Investment (average annual rates)

Country or Group	Growth of GDP 1960-70	Growth of GDP 1970-79	Growth of Investment 1960-70	Growth of Investment 1970-79	Investment as of % of GDP 1960	Investment as of % of GDP 1979
LDC-NICs						
Low Income						
India	3.4	3.4	5.5	5.8	17	24
Middle-Income						
S. Korea	8.6	10.3	23.6	14.9	11	35
Hong Kong	1.0	9.4	6.9	12.5	18	28
Singapore	8.8	8.4	20.5	6.0	11	39
Brazil	5.4	8.7	7.0	10.1	22	23
Argentina	4.2	2.5	4.1	3.0	22	26
Mexico	7.2	5.1	9.6	6.9	20	28
NEXT TIER						
Low income						
Indonesia	3.9	7.6	4.6	14.8	8	23
Pakistan	6.7	4.5	6.9	0.6	12	18
Middle-income						
Malaysia	6.5	7.9	7.2	10.3	14	25
Philippines	5.1	6.2	8.2	10.6	16	29
Thailand	8.2	7.7	15.8	7.7	16	28
Colombia	5.1	6.0	4.5	5.5	21	24

Source: World Development Report, 1981

IV. Structural Interdependence Between the U.S. and Developing Countries

During the 1970s the US and the developing economies, especially those which are rapidly-growing and industrializing, have developed another type of interdependence, which we will call "structural interdependence." This is the type of interdependence contemplated by classical or neo-classical trade theory, in which economies specialize along lines of comparative advantage in production, and then trade with each other to obtain a diversified consumption bundle. In standard trade theory, all goods are final goods, so complementarities are achieved by specialization in production of final goods.

In U.S. trade, however, there is an increasing trend toward specialization in production of capital goods, chemicals, and agricultural product, in exchange for imports of fuel, autos, and consumer goods. These trends are documented in Branson (1980). A summary is provided in subsection A below.

In its trade with developing countries, the U.S. has rapidly growing exports of capital goods and imports of consumer goods. As the developing countries industrialize, they import U.S. capital goods. In 1980 the U.S. surplus on trade in capital goods reached approximately $45 billion. In exchange, the U.S. imports final consumer goods. This is an example of comparative advantage at work, making the two sets of economies structurally complementary, or interdependent. The result is increasing efficiency, in general, but if the process moves too quickly it can generate significant adjustment costs.

In subsection B below we look at the growth in capital goods exports to developing countries, and in subsection C we look at U.S. consumer goods imports. Section D summarizes.

A. The Composition of U.S. Trade

At the end of World War II, the pattern of U.S. trade was distorted by the fact that industrial capacity had been significantly reduced in the other major advanced countries. Trade in consumer goods provides a good example of this distortion. In every year from 1925 to 1938 the U.S. was a net importer of consumer goods. But in 1946 the U.S. emerged from the war as a net exporter, and in 1947 the surplus on consumer goods was $1 billion. As industrial capacity was rebuilt in Europe and Japan, the surplus shrank steadily, and in 1959 the U.S. again became a net importer, with a deficit in consumer goods that has grown steadily since then. This example is typical of the pattern we see in the long-run data on the composition of trade. During the years since 1950 the composition of U.S. trade has moved back toward its longer-run base of comparative advantage. By the mid-1960s we see growing surpluses in trade in capital goods, chemicals, and agriculture, and deficits in consumer goods and non-agricultural industrial supplies and materials. Trade in automotive products switched from surplus to deficit in 1968. The evolution of the composition of U.S. trade is discussed in detail in Branson (1980).

The U.S. trade position in 1980 is an extension of the trends detailed there; it is summarized in Table 6. There we show

TABLE 6: U.S. TRADE, 1979-80

($ billions, annual rates)

Category	1979 Exports	1979 Imports	1979 Balance	1980 Exports	1980 Imports	1980 Balance
Total	187.5	211.8	-24.3	227.3	249.3	-22.0
Agricultural	33.6	17.4	16.2	42.2	18.1	24.1
Non-Agricultural	151.9	194.4	-42.5	185.1	231.2	-46.1
Non-Agricultural Industrial supplies and materials	52.1	110.4	-58.3	64.8	134.5	-69.7
Petroleum	2.0	60.5	-58.5	2.8	78.9	-76.1
Chemicals	14.5	4.5	10.0	17.8	5.2	12.6
Capital Goods	58.8	24.6	34.2	74.1	30.3	43.8
Autos	18.2	25.5	-7.3	17.3	27.1	- 9.8
Consumer Goods	12.8	30.6	-17.8	16.7	34.4	-17.7
Military	3.0	-	3.0	3.3	-	3.3
Other	7.0	3.3	3.7	8.9	4.9	4.0

Source: Survey of Current Business, 6/81,
Table 3 of"U.S. International Transactions, First Quarter 1981"

U.S. trade in 1979 and 1980, by major end-use categories. The patterns of surpluses and deficits are instructive.

The surpluses in capital goods and chemicals have grown since the period just after World War II. These are clear areas of comparative advantage. The deficit on consumer goods we already have discussed; that on autos has existed since 1968. The deficit on petroleum is obvious, and the agricultural surplus became a major element also around 1974.

If we aggregate the data slightly differently, we see more clearly the post-1974 adjustment in U.S. trade. In 1979, the deficit on trade in petroleum of $58 billion was substantially offset by surpluses of $18 billion in agriculture and $16 billion in non-petroleum manufactures, leaving a net trade deficit of $24 billion. In 1980, the petroleum deficit was $76 billion, but the agricultural surplus was $24 billion and the manufactures surplus was $30 billion, leaving a net deficit of $22 billion.

Thus the petroleum deficit is largely offset by surpluses in agriculture and manufacturing. Within manufacturing there is a clear division by comparative advantage, with a very large and growing surplus in capital goods and smaller but significant deficits on consumer goods and autos and a surplus in chemicals. In its trade in manufactured goods the U.S. is becoming increasingly specialized along lines of comparative advantage.

The U.S. economy has responded to the oil price increase, which is generating a $76 billion deficit by 1980, by expanding its trade surpluses along its lines of comparative advantage. The degree of adjustment is indeed quite remarkable; by 1980 the total trade deficit was $22 billion. The movement in the real exchange rate helped, improving the U.S. competitive position. Thus it appears that adjustment has worked well in the U.S.

B. U.S. Exports of Capital Goods to Developing Countries

A striking development in U.S. trade in the 1970s was the acceleration of growth in capital goods exports and the surplus in trade in capital goods, which was nearly $45 billion by 1980. During the mid-1970s there was a quantum jump in U.S. exports of capital goods to oil exporters and to industrializing developing countries [Branson (1980), p. 220]. Growth in capital goods exports to these countries continues to increase, and should provide an area of strength for U.S. trade on the 1980s. Rapid growth in manufacturing capacity in the developing countries is clearly good for the exercise of U.S. comparative advantage in capital goods exports.

Table 7 presents data on U.S. exports of capital goods, in constant 1979 dollars. Table 8 presents the growth rate summary of the data in Table 7. In Table 7 we see rapid growth in spurts throughout the period since 1965. The period 1965-72 saw fairly steady growth from $13.6 billion to $24 billion (1979 dollars). Then there was a jump in three years to $43.5 billion in 1975, a pause to 1977, and then another jump to $67.2 billion in 1980.

The data for exports to the developing countries show differing patterns of growth in the 1970s. To Latin America we see a doubling of exports in 1972-75, a pause,and another jump in 1977-80. The major period of growth in exports to the Near East ended in 1976. The growth in South Asia has been irregular, with a surge in 1976-80. Southeast Asia resembles Latin America, with the jump in 1972-75, a pause, and another jump in 1977-80. A peak in Africa was reached

TABLE 7: U.S. EXPORTS OF CAPITAL GOODS (TOTAL) (1979 $ MILLION)[a]

Year	U.S. Total Exports	Latin America	Near East	South Asia	S.E. Asia	Africa
1965	13600.1	2065.6				
1966	15025.3	2379.2				
1967	16575.0	2533.3	492.0	362.8	986.6	744.0
1968	17690.8	2823.8	615.3	271.9	1112.1	854.1
1969	19165.5	2880.2	640.1	192.3	1217.1	993.0
1970	21783.5	3262.9	633.1	326.8	1323.6	1055.0
1971	22094.9	3106.2	883.9	325.3	1518.1	1176.4
1972	24005.8	3657.3	1009.8	260.8	1758.0	1106.9
1973	30670.9	4412.2	1269.2	177.9	2605.2	1441.4
1974	39968.6	6322.9	2060.2	374.3	3560.8	1779.9
1975	43527.9	7241.3	3686.6	410.2	3873.5	2629.3
1976	44517.4	7169.5	5113.0	394.4	4144.3	2901.5
1977	43697.2	6926.5	4717.9	410.7	4244.0	2700.9
1978	48745.3	8004.6	4841.2	462.3	4701.1	2536.2
1979	57563.8	9725.4	4401.1	670.0	6528.5	2457.0
1980	67246.2	11555.6	4438.4	776.4	8260.3	3121.5

[a]Data were deflated using the U.S. implicit deflator for durable goods.

Source: Department of Commerce

TABLE 8: U.S. EXPORTS OF CAPITAL GOODS, TOTAL (ANNUAL AVERAGE GROWTH RATES)

Year	U.S. Total	Latin America	Near East	South Asia	S.E. Asia	Africa
1965-70	9.4	9.1	-	-	-	-
1970-75	13.8	15.9	35.2	4.5	21.5	18.2
1970-73	11.4	10.0	23.2	-20.2	22.5	10.4
→ 1973-80	11.2	13.8	17.9	21.0	16.5	11.0
1975-80	8.7	9.3	3.7	12.8	15.1	3.4

Source: Table 7

in 1976, with a jump in 1980. The general impression is that exports of capital goods to the Near East and Africa follow jumps in the oil price, and that exports to Latin America and South and Southeast Asia are tied to growth in manufacturing output in those areas. In 1970, exports to the developing areas shown in Table 7 were 30 percent of total capital goods exports; in 1973 this share was 32 percent, and by 1980 it was up to 42 percent.

Table 8 gives the growth rate summary for total capital goods. Let us focus on the period 1973-80. During this period U.S. real GNP grew at an annual rate of 2.4 percent. In Table 8 we see that total capital goods exports grew at 11.2 percent, substantially faster than total real demand. Since the share of exports to developing countries was rising over the period, they were growing faster yet. As we run across the columns in Table 8 for 1973-80, we see that exports of capital goods to each developing-country area except Africa grew faster than the total. Thus in the 1970s growth in capital goods exports was much faster than growth in total U.S. demand, and the share of the developing countries as a market for capital goods exports grew. Growth in manufacturing capacity in the developing countries, based significantly on international borrowing, appeared as demand for exports of capital goods in the U.S.

C. U.S. Imports of Consumer Goods from Developing Countries

U.S. imports of non-automotive consumer goods have also grown increasingly rapidly in the 1970s. By 1980 the overall deficit in trade in this category was $18 billion, small in comparison to the capital goods surplus, but still significant. U.S. imports from developing countries grew from 25 percent of total non-automotive consumer goods imports in 1970 to 52 percent in 1980. Thus as U.S. imports of consumer goods from developing countries grew in the 1970s, U.S. exports to them provided the basis for expanding these consumer good industries. To some extent, the growth of consumer goods imports in the U.S. released resources to provide for the expansion of capital goods exports. The U.S. economy became increasingly interdependent with the economies of the developing countries through this pattern of growth in trade.

Table 9 presents the data in U.S. imports of non-automotive consumer goods, in constant 1979 dollars, and Table 10 gives the growth rate summary of the data in Table 9.

In Table 9 we see fairly steady growth in total imports of non-automotive consumer goods except the recession year of 1975 and the growth recession that began in 1979. In the data for imports from Latin America we see a quadrupling from 1970-74, a drop in 1975 and more gradual growth since. Imports from the Near East and South Asia show steadier growth paths, with South Asia the steeper. Imports from Southeast Asia doubled from 1970-74, paused in 1975, and

TABLE 9: U.S. IMPORTS OF CONSUMER GOODS (NON-FOOD, NON-AUTOMOTIVE (1979 $MILLION)[a]

Year	U.S. Total Imports	Latin America	Near East	South Asia	S.E. Asia	Africa
1965	7311.9	117.3				
1966	8351.8	140.9				
1967	8813.1	180.6	169.3	55.5	1172.1	165.2
1968	10690.3	236.8	210.7	71.8	1594.2	172.8
1969	12439.6	285.4	222.8	78.2	2088.8	164.9
1970	13795.0	372.3	208.6	78.2	2590.4	145.2
1971	15145.4	457.8	230.7	84.7	3046.3	220.4
1972	19416.2	685.0	308.3	129.8	4237.7	248.6
1973	20810.9	1033.0	368.1	165.3	5065.3	308.2
1974	20374.2	1565.3	318.2	222.7	5124.7	246.8
1975	17620.4	1186.4	304.6	276.5	4881.7	565.4
1976	22860.8	1401.3	384.3	336.3	7629.0	560.3
1977	26498.3	1558.1	493.1	398.4	8864.7	731.9
1978	31153.9	1758.5	594.2	631.6	10846.7	779.9
1979	30269.3	1868.6	528.3	588.4	10877.4	1136.3
1980	31618.1	1885.0	577.9	613.2	11547.6	1654.3

a. Data are deflated using GNP Implicit Price Deflator for nondurable goods.
Source: Commerce Dept.

TABLE 10: IMPORTS OF CONSUMER GOODS, (NON-FOOD, NON-AUTOMOTIVE)
(ANNUAL AVERAGE GROWTH RATE)

Year	U.S. Total	South America	Near East	South Asia	S.E. Asia	Africa
1965-70	12.7	23.1	-	-	-	-
1970-75	4.9	23.2	7.6	25.3	12.7	27.2
1970-1973	13.7	34.0	18.9	24.9	23.4	25.1
1973-80	6.0	8.3	6.4	18.7	11.8	24.0
1975-80	11.7	9.3	12.8	15.9	17.2	21.5

Source: Table 9

then doubled again to 1980. Imports from Africa increased six-fold over the period 1970-80. The share of the LDCs in total U.S. imports of non-automotive consumer goods ran from 25 percent in 1970 to 33 percent in 1973 and 52 percent in 1980. Their total of $16.3 billion in 1980 was much less than U.S. exports of capital goods to them -- $28 billion in 1980.

The growth rate summary of Table 10 shows U.S. total imports of non-automotive consumer goods growing at an annual rate of 6 percent 1973-80, again faster than total real demand. Imports from each developing country area grew substantially faster, as their share increased. Thus as manufacturing capacity grew in the developing countries in the 1970s, their output found a market in the U.S.

D. Summary

In its trade with developing countries in the 1970s, the U.S. has become increasingly complementary and specialized. The overall composition of U.S. trade, reviewed in subsection A, has moved increasingly toward export surpluses in capital goods, agricultural goods, and chemicals, with deficits in autos, consumer goods, and fuels. By 1980, the U.S. had surpluses on the order of $25-30 billion on manufactured goods and agriculture.

In its trade with the developing countries, the U.S. is increasingly an exporter of capital goods and an importer of consumer goods, with a surplus on this exchange of about $26 billion in 1980. This fits well with basic notions of comparative advantage, and it reflects an efficient re-allocation of resources in the U.S.

This increase in structural interdependence with the developing countries also fits nicely into the picture of interdependence at the macro level. As the industrializing developing countries borrow internationally to finance growth, they buy capital goods from the U.S. In turn their manufactured consumer goods find a market in the U.S. The picture of interdependence through capital markets and through industrial structure is consistent and probably efficient in the long run.

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Representative RICHMOND. Thank you, Professor Branson.

Mr. Bergsten, it is a pleasure to have you here. You were one of the finest officials in the Cabinet in the Carter administration. So it was a pleasure to listen to you because you are so smart. All of you—Mr. Malmgren, Mr. Fox, and Professor Branson. We have got a really good panel today.

Let me throw out a lot of different issues which concern all of us, and perhaps if I throw out five different issues then we can go back and whichever gentleman feels like answering them can answer them.

Mr. Branson, I listened to your testimony. You think that we are temporarily in a slump, but you think we will get out of it. You also think we ought to develop better relations with developing countries.

Certainly General Haig's attempt to mediate the Falklands did more to hurt our relations with developing countries than anything we have done in the last decade. It was a totally no-win situation. He couldn't win in either case. The thing should have been handed to the Secretary General of the United Nations. As a result, now the few developing countries that did like us in South America are virtually going out of their way to ban American goods.

We, to this day, don't have a really intelligent policy on the one market that you indicated is available; namely, the market of the developing countries. You say we are in a temporary decline.

I wish what you said were true, except you find that machine tool orders this year, which should be 150 percent above what they were last year—because last year orders were abysmally low—and this year they are 50 percent of last year.

U.S. FACTORIES NEED REVITALIZATION

Now, American corporations must begin retooling and we have to begin realizing that the major enemy we have in the entire world commercially is Japan, which will be the No. 1 industrial power in the entire world in 1983. American industry has to somehow or another stop scrounging around and stop looking for acquisitions just to pump a few extra dollars into their treasuries. Our Government has to form some kind of reconstruction finance corporation. If we had an RFC, United States Steel would have been told, "OK, you can't buy Marathon Oil because Marathon Oil doesn't need you, and there is no way that if you will buy Marathon Oil you are going to help the gross national product by one single dollar. Take the $6 billion, put it into your own antiquated mills. We will give you another $X billion at 20 years at 9 percent."

Then United States Steel would have, say, $12 billion with which they can start modernizing their steel mills, which are in deplorable condition. For the world's greatest steel making power to be in such a decline is an international embarrassment. Here we are spending a $1.5 trillion building up our Defense Department. How can you go to war if you don't have modern steelmaking capacity and modern shipbuilding capacity? It boggles the mind that we ship our copper ore to Japan to be refined and the Japanese ship us back ingots.

And our Government has no industrial policy. No one is even thinking of an RFC. No one is even thinking of saying to the presidents of corporations, "OK, you want profits, fine. You invest your own money. We will back you up some with ours."

Mr. Bergsten, we were discussing the Japanese budget deficit. We have got to realize there are two types of deficits in this world. One is the very sick, cancerous deficit which we in America are generating.

There is no way the President's budget can pass with something like $110 billion of deficit. We as businessmen, Mr. Malmgren, we know what happens when businesses are at a loss. We clean house. So instead of saying, "This year my tax bill will probably be $40 million or $20 million," you said, "To heck with it, my earnings aren't as good as they were last year. I might just as well clean house and only pay $10 million in taxes."

So, my feeling is that due to the increased unemployment; and I expect unemployment is going to get to 10 percent next month, officially. In my opinion, if you consider people employed on a part time basis, for example, our unemployment in the United States is much closer to 12 percent than 10 percent.

We must recognize the fact that this deficit, whatever budget these two bodies finally pass, won't be true because the tax income won't be there. I am expecting the deficit this year of $185 billion.We know American people are only saving $200 billion. Then where is the American businessman supposed to get some money to retool?

Now, I know most American managers would like to improve the quality of their factories. They would like to robotize. They would like to automate. They would like to put in whatever quality control devices are necessary. They would like to conveyorize. But all of that is incredibly expensive.

Now, who can go out today, Mr. Malmgren, who can go out today and pay 18 or 20 percent interest for a new lathe, a new conveyor system? Who is willing to put up $10 million for a conveyor job even though it will save employees, keep the merchandise from getting itself nicked and cracked and keep the quality up? Who is willing to pay $2 million a year in interest for the privilege of having that conveyor established? Right?

HIGH INTEREST RATES PROHIBIT INDUSTRIAL RETOOLING

Until we get interest rates down in this country we are never going to see a resurgence as an industrial power. And anybody who says we are a superpower ought to just forget the word "superpower." The superpower in the world today is Japan.

The Soviet Union is spending half its gross national product in its paranoid desire to build up its "defense." We have no policy, so, God knows what we are doing with our excessive military spending. But one thing sure is we are not doing enough to encourage the American businessman to retool.

And I know, and Mr. Malmgren knows and Mr. Fox knows—every one of America's businessman would give his right arm to modernize his factory and make a better quality product. You know our businessmen, our factories, in the heartland of the United States, those people are wonderful, honest, hardworking people. They want to make a good product. They want to compete. But they just don't have the 20 percent interest to be able to afford it.

Now, until we get the Federal budget deficit to where it is not taking every dime of American savings I just don't know how we are ever going to get American industry back on the track.

ENCOURAGE JAPANESE INVESTMENT IN UNITED STATES

Now, to tell the Japanese that they have to cut out financing exports, that is just nonsense. The Japanese Government is a controlled government. Someone we had at one of our past hearings said, "Well, MITI can't really be very important because MITI—their budget is only 1 percent of the total Japanese budget."

The Ministry of International Trade and Industry controls the banks, the insurance companies, which in turn control industry. Their cousins, aunts, and uncles are all in executive positions in these companies. They have a cooperative at a total, total, total close association with the Ministry of Finance.

Any time any Japanese corporation has an opportunity to make money by exporting half a million dollars worth of telephone equipment to Zaire, let's say, they have no problem going to the Fuji Bank and a few other banks to pick up the money. Why not? The money is running out of Japanese ears.

As our chairman said, he would immolate himself to get them to put some money in Milwaukee, and I would do the same. What I keep telling the Japanese is: "You have too much money. You have too much ability. You have too many people. You don't have enough space. You don't have any natural resources. Isn't it time you came to the United States and you started investing your money here the same way some of the other foreign investors did?"

I told Mr. Toyota, "Mr. Toyota, you've got so damn much money in your balance sheet it is a disgrace. It is not doing any good. Take the money and go buy Ford." And then I told Mitsubishi, "Mr. Mitsubishi, your budget is one of the largest budgets in the world. Take the money and go buy Chrysler. We would welcome you anywhere. We would welcome your money, your technical ability, and you and our own American manufacturers could then run a couple of fine companies."

And I think gradually it is coming—you know, finally they are figuring out that that is perhaps the way they had better go. But look at the situation you have in Japan now. The average worker takes half his profit-sharing bonus which he gets twice a year, puts it right into the same bank—let's say Fuji. Let's say he works for a company—let's say he works for Fujitsu, the big robot company. Fujitsu is virtually a subsidiary of the Fuji Bank. Obviously, the Fuji Bank has a branch in Fujitsu. So when the Japanese worker picks up his profit-sharing check, what does he do? He goes down there and puts half into the bank and the other half into postal savings bonds. So the postal savings bonds, on which the Government pays 5¾ percent, allow the Japanese Government to run their Government at a deficit because every single part of the Japanese deficit is not a wasteful deficit like ours. It is not for making tanks and MX missiles and things that can't be used. It is for making efficient railroads. efficient health systems, efficient education systems, and it only costs them 5¾ percent.

Just think what we could do in this country if it only cost us 5¾ percent. The other half of the Japanese savings go into Fujitsu, Fuji's bank, and right back into one of Fuji's companies at 5¾ percent.

You know, once and for all, the American people have to realize what we're up against. This great country of ours is supplying the

Japanese with nonrenewable—Mr. Branson, as you said, we are supplying Japan with nonrenewable natural resources, with no labor content. And in turn, we are getting back a bunch of manufactured goods which we don't need, that we could live awfully well without: video tape sets, for example.

So, these are some of the things I'd like to discuss.

Also, I'd like somebody's opinion on the Soviet natural gas pipeline; and last, but not least, the impact of present American interest rates—which I can't see going down, they've got to go up—what is that going to do to the European economy?

And I think just one other item, if you can mention it. Apparently last night on a TV show about American interests at the Summit, Paul Craig Roberts was very complacent about the overvaluation of the U.S. dollar and the declining U.S. balance of trade. He said the current account is the real thing to watch. And the fact that we have a declining balance in trade doesn't bother him to much.

I know I have given you an awfully big order. Apparently we have to leave the room at 12:15 p.m., but I will try to leave the room at 12:30 p.m. because I'd like to hear from all of you. You are such a brilliant panel. I'm so interested in these subjects. If we could get some of this stuff on the record, I'd appreciate it.

Have I given you too much all at once?

Mr. BERGSTEN. Yes, but we'll try to handle it. [Laughter.]

Representative RICHMOND. You can handle anything, you know that.

Mr. BERGSTEN. Maybe I'll tackle the one you raised at the end of your comments about the dollar. I happen to have been on the program last night, where Craig Roberts did make the complacent comments you did mention.

OVERVALUED DOLLAR PRODUCING UNEMPLOYMENT

In response last night, I pointed out, as I did in my testimony this morning, that the overvalued dollar, on conservative estimates, is destroying something like 1–2 million jobs in the United States this year. And that seems to be—not to be a source of complacency.

The degree of dollar overvaluation probably will erode our trade balance somewhere on the order of $50–$75 billion by the time the damage is all done.

Already, despite the recession, there has been a substantial deterioration in our external balance, which has been larger in its magnitude than the decline in either the housing industry or the auto industry in pushing the economy into recession over the last year.

So, the effects are large. They can certainly not be taken with complacency.

MUST CONTROL OVERSHOOTING OF EXCHANGE RATES

And as I suggested in my testimony today, at Versailles, coming out of Versailles clearly has to be a process to quickly right the exchange rate misalinement in the short run, and I think also a process that we'll begin to talk about, improving the function of the monetary system so that these periodic episodes of overshooting that we're now seeing

in the exchange markets, which on several occasions now over the last few years have pushed dollar-yen and European currencies well away from their underlying equilibrium paths, are minimized.

We have simply got to get away from this excessive overshooting of the exchange rates by improving the system of exchange management that we have in the world today.

Well, I'm certainly not an advocate of going back to fixed exchange rates. I think, however, that there's a big difference between trying to set correct exchange rates, trying to fix them at a point and hold them there, on the one hand—I don't think you can do that, but I think you can get international agreement when exchange rates are clearly incorrect and take policy steps, joint intervention, public pronouncements, and targets that are announced to move rates back into what one might call target zones.

When the dollar was too weak, back in the fall of 1978, we initiated a $30 billion support program for the dollar. Federal Reserve, properly at that time, raised interest rates sharply, from 8 to 9 percent. That was a big increase at that time. There was full support by Japan, Germany, Switzerland, and others in supporting the dollar in the exchange markets, and it worked. And the dollar strengthened and came back. But now it has gone too far, and current policy takes a hands-off position toward the whole issue, says we shouldn't intervene, we shouldn't make any policy changes to affect it, we shouldn't talk about improving the monetary system to put a better framework around it.

Therefore, as you quite rightly said, the problem is going to continue under present policy.

CROWDING OUT OF PRIVATE INVESTMENT

Representative RICHMOND. Mr. Bergsten, our administration's financial policy has got to cause a stronger and stronger dollar.

Mr. BERGSTEN. That is the central problem.

Representative RICHMOND. You and I agree that the dollar is far too strong as it is.

Mr. BERGSTEN. I agree with you fully on that, that the huge budget deficits that seem to be indefinitely with us under current policy will crowd out virtually all private investment. That will keep interest rates high.

You see, the only reconciliation to the dilemma you pose is, of course, to import capital from abroad.

Representative RICHMOND. Which we're doing.

Mr. BERGSTEN. There is one escape from the dilemma you posed.

You pointed out, quite rightly, that the Government deficits will take virtually all savings generated in the United States. There is one dilemma, importing savings to the United States from the rest of the world.

One might call it the new style beggar-thy-neighbor policies, let's import capital from the rest of the world.

INFLOW OF FOREIGN CAPITAL

Representative RICHMOND. We are importing capital. No one realizes that a major contributing factor in the salvation of New York City was the terrorism in Europe. You'll never read a word in a newspaper

in this entire United States that will tell you that one key reason New York City was saved from bankruptcy was the incredible terrorism in Europe, which has led vast numbers of rich Europeans to put more and more of their money in America. Where else can they put it? Even if they don't get a good return, they know it's safe.

When they come here, they buy real estate. As a result, we're getting overbuilt in New York City again. I guarantee you there's not one single building being built in New York City today with American money.

My worry is that the foreign money that's coming in is usually for fixed major investments at long term. I'm worried about Mr. Fox's members. I want them to get a little money to start modernizing their factories so we can compete in the world with a quality product. Why should Americans have to buy half of our manufactured articles in Japan—articles we originally invented?

Mr. Fox and I know that our middle-American manufacturing people are first-class manufacturers if given half a chance.

Mr. BERGSTEN. Just to dramatize that point, it is worth remembering quite recently, 1978 to 1980, that 3-year period, U.S. exports grew at twice the rate of world trade, and not much more than a year ago the U.S. share of world exports of manufactured goods was higher than it had been a decade earlier, reversing the competitive losses of the earlier part of the decade.

Now, what that says to me is the United States can compete. And if we only get the exchange rate back into whack we'd have a very good chance of doing very well, including the manufacturers in the Midwest.

Representative RICHMOND. I think we have to get the exchange rate back and we have to also begin a major retooling operation.

And if you think the Japanese are going to do anything to strengthen their currency, I don't agree with you, because they have got their people willing to accept a 5¾ percent interest, they can run their country at 5¾, which gives them one heck of a competitive market, a competitive edge in world trade. Their banks have nothing but money to finance those companies so that they can undercut everybody. I just don't see the Japanese cooperating.

Our chairman said the Japanese ought to agree to an import surcharge. That will be the day.

SOVIET GAS PIPELINE

Mr. MALMGREN. Congressman, you have raised a vast array of questions, but they reflect a deep frustration which I think everybody has in politics and in policymaking and in business. But let me begin with the Soviet gasline, and then I'll talk about this bigger issue for a moment.

The Yamal pipeline is an issue which has become blown up many times the size of the problems, but there is a deep division of thinking between Europe and the United States. And I think it should be understood that that division of thinking includes the following elements:

First of all, the European judgment is that if you reduce economic ties with the Soviet Union, you make the economic people in the Soviet Union look weaker and dumber because their side of the system is getting pretty weak, and you strengthen the hawks in the Soviet Union—and they don't want to do that right now, because they've got to live with these people, they're next door.

Second, the view is the Soviets are in big trouble on their foreign exchange, no matter what happens. So, the Yamal pipeline is not going to fill the gap in their view, it's going to relieve the pressure slightly. But they don't want a lot of pressure. They don't want the Soviets so damaged by their own policies that they start looking around for expansion elsewhere. So, they want a moderation, a kind of policy of relationships that continue but don't get out of hand, don't get too fast.

The technology part of this is, frankly, bunk. The technology for the pipeline is available in the world marketplace. If the United States doesn't want to sell it, somebody else will.

We're not going to be able to reach back to patents we licensed 20 years ago or 10 years ago.

Now, we have also not recognized that for the Europeans to rely on Algeria is not exactly the safest type of source. So, we are saying, "Well, if we add another risky source, we're diversifying our risks." In my view, this is no big problem. And it really is time for us to back off on this. But I think the President has already backed off. It's the people under him who haven't quite figured out where the President is.

The problem of——

Representative RICHMOND. It would be nice if people talked with each other.

Mr. MALMGREN. In Washington, it's a big problem getting the President to talk to bureaucrats, and vice versa. Usually the bureaucrats have their own power structure, and I am sure you have wrestled with them long and hard as a Congressman.

INTERDEPENDENCE OF NATIONAL ECONOMIC POLICIES AND MARKETS

Now, if we get to the broad issues of economic policy, what the summit leaders are really wrestling with is the fact that none of them has the power to manage their own economies without looking at the policies of other countries. We really can't manage national economic policy on a national basis solely. You can't run your monetary policy that way because external monetary movements affect the domestic monetary aggregates. You can't look at one part of the economy without looking at other parts. People park their money in commodities one night, in money the next. These are all interchangeable.

What we're seeing is a change in the nature of the economic framework we're dealing with. We've got a world marketplace. We have a certain amount of sovereign power domestically, but it's limited. And we have to talk to other countries. So, now the summit leaders will agree to start talking about how they coordinate.

The United States won't like it because the others say, "How we coordinate is you change your policy."

The United States will say, "No, no. You adopt ours."

It's going to be a little bit of a squabble for a while. My guess is we'll have a correction in our own policy in the fall and suddenly it will start to work.

Representative RICHMOND. You probably agree the problems of the European Economic Community and those of the United States are similar and we should work as closely as possible to cure both our problems because if one of us is sick, the other is going to get sick.

Mr. MALMGREN. I agree completely. In my prepared statement, I said if we concentrate on keeping the West together and strengthening it, it's a lot more important than fighting the ephemeral issue of the pipeline.

Representative RICHMOND. I think the pipeline is the greatest thing since sliced bread. It gives us an opportunity to pick up $15 billion worth of hard foreign exchange from the Russians. You build the pipeline. It's a great opportunity for the Russians to make some foreign exchange if they are decent international citizens. And if they don't become decent international citizens, someday perhaps the Western Europeans might not need the gas.

Mr. MALMGREN. Dependence cuts two ways. When you want to buy and you're dependent on somebody, that's one sort of leverage. But it works the other way, you can turn off the buying.

Representative RICHMOND. Exactly.

I think we should encourage the pipeline, not discourage it.

Mr. MALMGREN. We're in agreement on that.

Representative RICHMOND. It's $15 billion.

Mr. MALMGREN. On these bigger issues, the interest rate problems we face are not going to be resolved until the budget crisis is resolved.

Representative RICHMOND. Which is not going to be resolved until 1984.

Mr. MALMGREN. My estimate for a budget deficit is higher than yours. You say $185 billion. I say $200 billion, because I believe unemployment will be a lot higher than presently reckoned.

Representative RICHMOND. You agree corporations are not going to be particularly anxious to pay extra taxes because money is so valuable.

Mr. MALMGREN. There are corporations that have been running losses in the United States for the last 2 or 3 years, because tax losses carried forward will not bring taxes for 5 or 6 years from now. You're not going to get any pickup in tax revenues from the corporate world no matter what you do.

The estimates are all out of whack. The budget deficit is much worse than it seems. I'm not counting the cost overrun problem in defense, which is much more serious than anybody is admitting. And the manpower costs in defense, if you adopt all this new technology, because you're going to have to raise salaries because you're not going to keep engineers in the military, manning all that electronic, sophisticated equipment, the budget problems are much bigger than they seem already. Nobody has recognized how big they are.

Representative RICHMOND. Everyone talks about a $100 billion deficit. But you and I know it's going to be closer to $200 billion, which takes every dime of savings in the whole United States.

UNITED STATES-JAPANESE JOINT VENTURES

Mr. MALMGREN. There are some positive developments Government is not involved in I just want to call your attention to. Not many people are aware of this.

Some of our companies, recognizing this mess, have decided to make love not war. They have gone to work with the Japanese. There are a lot of cross-border cooperation and arrangements going on. GE and

Hitachi are working very closely together in a lot of industrial products. Fujitsu and IBM are now working together in certain areas of robots, Kawaski and Unimation—Unimation is our biggest automation producer—GM has now announced they're going to go into robotics and work with Japanese. It's going to make cars with Toyota, probably which would be good for GM.

There are a lot of these developments going on in the private sector anyway. I think those developments will reduce the tensions with Japan and get Japan more directly involved.

Let me point out it's not necessarily desirable for us, for Japan to build an auto plant in the United States. Everybody says that will be a solution.

AUTOMATION

If you build a modern, state-of-the-art, Japanese plant in the United States today, there'll be hardly any workers, and it will be totally automated. It would build a big hole in the side of GM. I'm not sure you really want that. It's not going to gain jobs.

Representative RICHMOND. My feeling—I hate to interrupt—on automation is the better your product, the higher quality your product, the more efficient your product, the higher sales you have.

Now, Japan has been automating every one of its factories. They say, "Oh, we have lifetime employment." You know, this "lifetime employment" is a figment of somebody's imagination. The reason they have lifetime employment is their sales have gone up every single year, therefore they can afford to have lifetime employment.

Mr. MALMGREN. You put your finger on something, Congressman. That's right, they're moving toward automation. But they have a way, because of their growth, to absorb the unemployment problem. We're not going to have that kind of growth unless we change our policy.

So, we're going to have automation in the 1980's, but we're not going to have a means of absorbing the unemployment problem that results from it.

We're going to have big difficulty taking care of the autoworkers in Detroit.

Representative RICHMOND. We are producing 6 million cars a year. You know that we can produce 12 million.

We are producing 900,000 housing units. You know we should be producing 2 million units of housing.

Can you imagine if this country can get back into producing what we should produce?

How many people would be employed even with robotics and with automation? Robotics so far are only good for a couple of jobs that people don't want to do. People don't want to get into a paint cubicle and paint things because it's bad for their lungs. Another thing people don't want to do is welding.

Mr. MALMGREN. I know what you're saying. I know the machine tool industry is something you are familiar with. I talked to the national machine tool builders a few weeks ago at their annual meeting. They asked me to lay out their technological challenge to them and their industry. A lot of those people are not investing in anything, putting their money in treasuries and earning their 15 percent.

At any rate, I said you gentlemen have got to understand the technology in robots is moving very fast. I happen to be in this field very intensively in strategic planning for international companies. It's moving so fast that a good deal of what machine tools do today will be replaced by robot types of activity tomorrow.

Representative RICHMOND. You're saying robot. What you really mean is that a good deal of what is machine tools today will be replaced by another machine tool which will be controlled by a computer with an automatic loader and unloader.

Mr. MALMGREN. Robots will not be made by people. They will be made by robots. The newest factories in Japan—there are about 15 or 20 people in a robot factory that makes 20,000 units a year.

Representative RICHMOND. I was at that factory. They advertise their third shift has only one person.

Mr. MALMGREN. The new Fujitso plant, that's it.

Representative RICHMOND. I'm thinking of Yamasaki.

Mr. MALMGREN. Fujitso is building one in Luxembourg with Siemens. The Luxembourg Government got all excited, thought they were going to get a lot of jobs, and discovered they were only going to get 100 jobs out of a plant that will do almost all the robots in certain fields for Europe. The progress in this field is moving so fast——

Representative RICHMOND. Mr. Malmgren, look what we have to do to get this country to snuff. Look what we have to do with our transportation. You can't use your robots for that. You need human beings. Think what we have to do to put our highways and bridges back in shape. People will have to have a different type of educational background for the new jobs. They won't get that because we are now gutting our education system with present policies so our people will not be changed for the new jobs.

In Japan, why is it that people can adjust so readily? How do you take a steelworker and put him in the office so readily? The answer is all education up to a certain level is the same. Everybody is getting a homogeneous backgound. Evey person is supposed to be interchangeable with every other person and they don't train you to be technical until a much later stage in your education. They train you to be versatile. You get your mathematics, your language, orderly way of thinking. Everybody gets it. There is a 2-percent illiteracy rate. It's an extraordinary situation. They can move people around.

We don't have that. We need it. We don't have a human resource policy. We don't have a forward-looking policy on technology, the economy or anything.

You probably consider yourself a conservative. I consider myself a liberal. What are we both saying? One thing this Nation needs is a 100-percent literacy policy. We shouldn't let people out of high school until they are absolutely literate.

Mr. MALMGREN. I think probably the most important issue in foreign economic policy is our domestic education policy; second is our technology policy at home, not abroad. When you get those things squared away you can negotiate with other people. To thrust on the world and our domestic industry the idea that you can solve the problems by international negotiation, frankly, we will not solve problems that way.

Representative RICHMOND. Let's clean house first.

UNDERVALUED YEN BENEFICIAL TO JAPANESE INDUSTRY

Mr. Fox. Congressman, I would like to make a point of emphasis. I don't believe our problems with Japan are likely to be substantially resolved, as Hal Malmgren suggested they might be, through more cooperation and intercompany agreements with the Japanese. That might help GM and it might resolve certain difficulties, but I don't believe that that goes broadly enough across the board. Nor do I agree with Professor Branson when he suggests the exchange rate is not all that important with respect to Japan. I think the Japanese competitive advantage is growing and is substantial, and the exchange rate disparity which is very substantial simply makes it impossible to deal with that situation.

My suggestion is very much along the line of Fred Bergsten's. Until we resolve the exchange rate problems, these other matters which are tough enough to deal with can't be resolved.

Representative RICHMOND. Mr. Fox, we can't resolve the exchange rate until we start running our Government in a more intelligent fashion. Could one of your manufacturers run his company the way we run our government? Is this the time to cut taxes when we're going to have a $200 billion deficit?

Mr. Fox. My suggestion is, with respect to the exchange rate, without it necessarily being a charge by the United States that Japan is manipulating the exchange rate regime, that a discussion take place in the IMF under the provisions and objectives of article IV to see what the circumstances are and how they may be corrected; that if it produces the extraordinary result of a depreciating currency in the case of the country, that everyone regards as the one that's gaining the most in competitiveness and that has the best prospect in that regard.

Now, I think some approach dealing with target zones is likely to be the outcome of that. It's not satisfactory, however, for the Japanese to say there's nothing we can do. It's all in the interest rates with the dollar. If one looks at the previous history, the Japanese economic policy has really posited and benefited from an undervalued yen. That was the situation that was made extremely simple by the Bretton Woods Agreement until 1981. We just handed it to the Japanese.

Representative RICHMOND. How do you force them to raise their interest rates when they don't have to?

Mr. Fox. I think what we do is look at the alternatives. Until such time as the yen is more internationalized and the Japanese monetary system is influenced by the developments abroad, there are some alternatives. I'm not as keen on Mr. Bergsten's capital controls as I would be on the temporary export tax in the case of Japan.

They could use the revenues to finance imports or to provide an import subsidy. The Japanese Government would not want to do that. It really puts it to them if they can't do it any other way, do you really want to do it. In truth, the Japanese would like to have a yen-dollar rate of about 200, but not do any of the painful things that would result from that.

Representative RICHMOND. 200 wouldn't do—what would it do?

Mr. Fox. I'd like 175 better than 200.

Representative RICHMOND. You'll never even get to 200.

Mr. Fox. I like the suggestion Mr. Bergsten and I have put forth at the same time. Let's decide how far you can go this year: 200, although it may not be enough for 1982, would point the way. But if we keep on saying that there are other things that are more important, getting the American school system working better, getting the U.S. budget deficit down, those are all very essential elements, but until it's put to Japan if you really think 200 is right, then you've got a responsibility to help get there. You simply can't go to all these conferences and say it's high U.S. interest rates.

Representative RICHMOND. Mr. Fox, they won't do it. They'll talk you to death, the way they're talking to our Trade Negotiator. Bill Brock and his staff are being talked to death night and day. The Japanese say we'll do this, we'll do that. They finally, after 3 years, settled on some 90-odd items.

Mr. Fox. Wait. There will be another package.

Representative RICHMOND. The whole 90 items don't come to $200 million worth of sales a year. The Japanese are not going to give in.

Mr. Fox. I really feel it's necessary to address the unrealistic——

Representative RICHMOND. They'll talk and talk and end up doing absolutely nothing. You know that.

Mr. Fox. I think, though, if that is the case, we're going to have great difficulty.

Representative RICHMOND. Until we Americans get on to what is going on and the Europeans get on to what is going on and tell the Japanese, "Fellows, the party's over, we want equal trade, we're sick and tired of your protectionism."

Mr. BERGSTEN. I think you're a little too pessimistic.

Representative RICHMOND. I wish I were, Fred.

Mr. BERGSTEN. No, about the possibility of getting the exchange rate right. This is the third episode of this type in the last 12 years. We had it late 1960's and early 1970's. We had it again in 1977. We've got it again now. It took very forceful U.S. action on those first two occasions to get the exchange rate moving in the right direction, in the second case to get the Japanese out of the market when they were holding the yen at a low rate. But strong action was taken in both those cases and the Japanese did respond.

This time what is critically needed is the kind of target setting that Mr. Fox just mentioned. Get it to the following level and make that point forcefully from the top of the U.S. Government in support with the European governments, maybe using Versailles as a venue in which to do that. Once you set the target and make clear the alternatives are very unhappy, I think it's possible.

Remember, the yen rate hit 180 to the dollar in 1978. It's not new terrain. In fact, it stayed in the 190 to 200 range for quite a while in late 1978 and early 1979. It's not new terrain. At that time MITI, your favorites, pointed out to the Japanese industry you fellows may have to live with an exchange rate in this range forever. Prepare yourselves to compete at this level. They can do it, they know they can do it.

MANIPULATE JAPANESE CAPITAL ACCOUNT TO REALINE EXCHANGE RATES

Now, I've made the proposal which I think is the only really feasible one, for getting there quickly, which is to manipulate the capital account. What I would have the Japanese do is two things, which is very similar to what they did only 2 and 3 years ago when they were running big current account deficits. First, declare a moratorium on capital outflow by Japanese; finance their direct investments abroad; stop buying zero coupon bonds but other foreign portfolio as well; for a temporary period sharply cut your capital outflow. Second, go out and borrow aggressively abroad, as the Japanese Government did 2 to 3 years ago, to promote the capital inflow into Japan. Those two changes would substantially alter the Japanese capital account and push the yen sharply in an upward direction.

I think that's feasible. In fact, many Japanese that have been approached with that notion have said it is clearly feasible, our administrative techniques permit us to do it, it is much less damaging in terms of our domestic politics than all these nontariff barriers changing our savings ratios and running big budget deficits. We can do it. But they have one problem, and it's a justified problem. They're afraid the United States would denounce them for doing it. They're afraid the U.S. administration would say you are violating the free market; therefore, it's bad.

Representative RICHMOND. They're violating the free market every day of their lives. so what's the difference?

Mr. BERGSTEN. Exactly. In the economic terms it's the theory of the second or third best, but it's a practical way to solve a very real and very urgent problem.

Representative RICHMOND. If you can get them to do it, fine. I don't believe they'll do it.

Mr. BERGSTEN. I disagree. I think they would do it if they had advanced word that the rest of the world would accept and support it as a central step to deal with the problem, and I think the rest of the world ought to give them that support.

Representative RICHMOND. That's a possible move that could be made at Versailles?

Mr. BERGSTEN. Absolutely.

Mr. MALMGREN. But this administration could not maintain its present philosophic and economic approach and do this. Does it have to abandon ship?

Mr. BERGSTEN. It did on sugar import quotas——

Representative RICHMOND. Wait a minute, Fred. Sugar has lots of votes in Congress.

Mr. BERGSTEN. I pointed out that they have been pragmatic on a number of issues in the same policy area. Mr. Malmgren rightly points out they have to get a bit more pragmatic. I'm suggesting there's ample precedent in the last 2 weeks for doing it. I don't see it's beyond their ken to achieve a major purpose like this.

Representative RICHMOND. I'm for you.

Mr. FOX. Congressman, if the Versailles Summit would agree that indeed the undervalued yen exacerbates the problems of unemployment in all of the other countries and the Japanese accept that, and then

say now it's up to us to figure out a way to get there, Mr. Bergsten may be right that this temporary control on the outflow of capital is the way to go. The longer term solution, though, is the internationalization of Japan's capital markets and the international role of the yen.

If a dual track was stated that that were the objective, Japan was prepared to see the yen become a key reserve currency, in order to get there it needs the cooperation of other countries, perhaps joint defense of this initial 200-to-the-dollar-yen rate. I think that would constitute a step in the right direction, particularly if there was the support of the IMF to help it work. And I think that is really in Japan's interest, because Japan is not likely to be a very happy country in the face of protectionism all over the world. And I think that recognition of that would permit some kind of agreement following the Versailles Summit to take the necessary steps, and it wouldn't be necessary for Mr. Sprinkel to say everything he said last week is wrong.

U.S. GOVERNMENT DEFICIT NONPRODUCTIVE

Representative RICHMOND. Except, Mr. Fox, in manufacturing, we have a saying: When it's not broken, don't fix it. Now, the Japanese economy is in great shape. They are generating more than enough capital at their 5¾-percent rate to expand, to modernize, finance exports, do anything they please, due to the fact that the people are willing to invest a lot of their savings at 5¾ percent into their own corporation and into the Government deficit. See, I consider deficits—Government deficits are perfectly OK if those deficits are being used for the common good and if the deficit can be financed at low-interest rates. What scares the devil out of me is that we're going to be financing our deficits, in my opinion, next year with 15- and 14-percent Treasury bonds for an awful lot of stuff that is not going to help the American people, like unnecessary MX missiles, unnecessary B–1 bombers, and so forth. We know, for example, that the day the first B–1 bomber comes off the assembly line the Stealth will be ready to go, yet we're going to spend billions upon billions on something that doesn't create anything for the national good.

The Japanese improve their transportation system—look at how many more hours of labor they get out of people that way. They improve the education system; look what you get with literacy. They improve their health system; look how many people you keep out of hospitals when you can build decent clinics. That's what they're using their deficit for.

When you use your deficit for that and you finance it at 5¾ percent, you are doing a brilliant job of running your country. What we are doing is to finance our deficit at 14 and 15 percent. And, moreover, we are taking most of that money and putting it into projects that really won't help the American people. That's what worries me.

Mr. FOX. Congressman, I'm really saying the world is not going to be able to coexist with Japan when so many of the advantages of world trade pile up only in Japan's corner.

Representative RICHMOND. What's going to happen?

Mr. FOX. The European community, at the time it took this article XXIII action in the GATT with respect to Japan, also directed its finance ministers to take up the exchange rate question. I have no idea

how that's going to finally come out. There's a very logical step to be taken, and that's for Europe to impose an import surcharge on Japanese goods by their measurement of the misalignment of the yen.

I'm not predicting that. I think it would be a lot better to get together, preferably in the IMF, and work out a solution. I say in the longer run that meets Japan's interests as well as those of the rest of us.

Mr. BERGSTEN. Mr. Chairman, again there is a little history here. The United States did impose an import surcharge 10 years ago, very much because of a similar problem, aimed primarily at Japan, so it's not as if this is all fresh ground.

Representative RICHMOND. Mr. Branson.

Mr. BRANSON. I wanted to object a little bit to the focus on exchange rates, because I think that can take you off the underlying problem which seems to me to be high real interest rates. It seems to me that it is not likely that one can get exchange rates realined in any substantial fundamental way unless the monetary coordination in the background is doing right. My suggestion is that in a way you are right with your focus on high real interest rates, and the machine tool industry story, that the heart of the problem right now is projected budget deficit and high real interest rates, which are the source of the overvaluation of the dollar. A coordinated monetary expansion, combined with a change in budget position in most of the OECD countries, in which Japan did not ease interest rates step by step with the others, would be a feasible solution to this situation.

I think that you might have heard my emphasis a little off focus. I don't think we are necessarily temporarily in a slump. It seems to me as long as real interest rates remain high, the situation gets worse. Therefore, I would say that the key to a whole series of problems is getting something done about monetary and fiscal policy, and that will have a side effect of doing something about the exchange rate which will then improve to a certain extent the trade situation. I still wouldn't want to take the risk of making a big bet that if we get the exchange rate, the dollar devalued, that is going to do something fundamental about the Japanese trade situation.

Representative RICHMOND. It's going to help a lot.

Mr. BRANSON. I don't think that it's going to cause as much of a reduction in their trade surplus, I guess, as Mr. Bergsten does.

Mr. BERGSTEN. It has twice before in those two early episodes I mentioned. There were other factors, but I think most of the empirical evidence shows that those were really decisive trade reactions to exchange rate changes.

Mr. BRANSON. We'll probably end up disagreeing about that.

The other idea I wanted to mention that you had brought up is this Reconstruction Finance Co. I think that's an idea that should get a hearing. I would worry about whether it's a reconstruction finance company that is going to subsidize industries that shouldn't be subsidized. It seems to me it's not altogether clear that what we want to do is subsidize the American steel industry or the American auto industry, in order to keep it—fend off competition.

Representative RICHMOND. Mr. Branson, you want to spend $5.5 trillion on defense the next 5 years?

Mr. BRANSON. No; but I don't want to spend it on autos or steel either.

Representative RICHMOND. Whatever we spend on defense, we better make sure we have a backup industry to back up defense. What good is defense if you don't have modern factories behind them; right? Everyone's forgetting about that.

Mr. MALMGREN. Congressman, when I first came to Washington in 1961, I guess, the Kennedy administration, I was in the defense area, and I never recovered from that experience. I went on to trade and other more pleasant things, but I never forgot some of the fundamentals, and this technological change that I referred to in my statement includes some developments that really raise doubts about whether steel is so vital. For example, the "Stealth" bomber will not be made of metal. That's why it's stealth. You can't find it with a radar, because it doesn't have metal.

Representative RICHMOND. Tanks will be made out of metal.

Mr. MALMGREN. I'm not sure. Carbon fiber technology is being developed in this country, Germany, and Japan. I think Germany and Japan may be a little ahead of us in that technology. That material has greater stress resistance than steel. than any alloy we know of in steel, has greater strength and greater lightness.

Representative RICHMOND. Mr. Malmgren, when I say "steel," what I'm really saying is a metal in general.

Mr. MALMGREN. It's not metal. This is junk coal that's put together with plastic, and it's made into something harder than any metal we know.

Representative RICHMOND. Why didn't United States Steel invest $6 billion in that instead of buying Marathon Oil?

Mr. MALMGREN. That's a good question. I think what's happening there is a financial problem that arises from the interest rate difficulty. United States Steel is diversifying its risks and finances, so it can run its investment tax credits from the profit-taking side of the business. It's a very natural development. Bethlehem is staying in steel, but they have very advanced technology. They have the leading labs in the steel industry, and I believe they will be able to make it, but each has taken its own route. Most of the companies, again, have to contract in the 1980's.

Representative RICHMOND. I fully agree that perhaps some of our basic steelmaking is unnecessary. I agree with you that all of these corporate decisionmakers should now be taking whatever money they have and, instead of buying real estate and shopping centers and unnecessary oil companies, they should be putting it into these new fibers and new fabrics, so they can stay in business.

Mr. MALMGREN. Long lead time and high risk, so you've got to get a heck of a higher return than just putting your money in Treasuries. That's the problem.

INFLATION PREDICTIONS

Representative RICHMOND. No. 1, how do you all feel about inflation for this coming 6-month period, then for the following year. Mr. Bergsten, give me a number.

Mr. BERGSTEN. I think over the next 6 to 12 months it will be in the 6- to 8-percent range. As the economy comes back a bit and the dollar

weakens, you'll get a reversal of some of the temporary factors that have pushed the rate down so fast in the recent past, but it will still be a lot lower.

Representative RICHMOND. Do you say 6 to 8 percent, Mr. Malmgren?

Mr. MALMGREN. He says that because he sees a bottom to this recession. I don't see it yet. So I don't see that recovery coming in the next 6 months. So I think it will be 5 to 6 percent.

Representative RICHMOND. Mr. Bergstein says 6 to 8; you say 5 to 6 percent.

Mr. Fox.

Mr. FOX. I'm very much on the lower end of that range, primarily, because I don't see the recovery coming along very fast.

Representative RICHMOND. What do you see?

Mr. FOX. Five percent.

Representative RICHMOND. Professor Branson.

Mr. BRANSON. Six percent.

Representative RICHMOND. So in other words—I'm inclined to agree with you, so we all see the inflation rate for the foreseeable future is going to be well within hand. We could all handle a 6 percent inflation rate.

Mr. BRANSON. As long as the recession continues.

Representative RICHMOND. I think the recession is here for several years to come, and if you want to talk to Senator Proxmire, he told me that we are in for stagflation for the next 10 years. I think he's exaggerating, but after all, Senator Proxmire has been around here for 25 years. He was chairman of Banking for 20 years. His opinion is we're going to have stagflation for the next 10 years. I think we're going to have it for the next 2 or 3 years.

Mr. BERGSTEN. Senator Proxmire's point is, don't take our 6 percent consensus as a great note of optimism, because that's a 6 percent inflation forecast, based on a very soft economy.

Representative RICHMOND. Which I think we're going to have for the necessary tuning up.

EUROPEAN INDUSTRY

My last question is, do you think the rather sick condition of the United States in every way, shape, form, and manner is going to further cause Europe to decline disastrously in the next couple of years, or do you think they'll be able to survive?

Mr. MALMGREN. The European industrial economy is going to have a tremendous amount of difficulty. There's going to be a lot of unemployment in Europe. The European leaders are going to be criticized and some of them will have problems. What's going to happen in that climate is that, if the United States shows steadiness of purpose and leadership and a sensible policy, they'll more or less stay with us, but if we show the sort of stop-go experimental approach of late, they will pull away and go in the wrong direction. I think it's going to be very unhealthy if that happens.

Representative RICHMOND. Mr. Bergsten.

Mr. BERGSTEN. I think they will survive, but I think there will be continued steady erosion of European movement away from an open trading system, cooperation with the United States, even the NATO

alliance. I think there's a real erosion. What Mr. Malmgren said can certainly accelerate the pace of that erosion, but I am afraid, given their underlying position, there's a real problem there, even under fairly optimistic assumptions about U.S. activities.

Representative RICHMOND. Mr. Fox.

Mr. Fox. I knew you were going to give me another chance at the exchange rate. I agree with the observations about Europe, and I think the prospects are quite gloomy, but bear in mind a large part of the growth in Europe in the past 25 years has been export-led growth. At this time that export-led growth is choked off by slow growth in the United States and elsewhere in the world economy. To the extent that Japan has a particular advantage in third country markets because of the undervalued yen, they make it harder for Europe to go in some way toward export-led growth while developing a more buoyant domestic economy. That route is cut off to a considerable extent, particularly if the United States is going to go for that export-led growth in heavy mechanical industries, as Professor Branson suggests we might be able to do.

So I conclude that for both the reasons of U.S. trade and the European interests in trade, an appreciated yen is quite essential. I think we have emphasized a bit too much this morning the bilateral trade balance with Japan. We could live with bilateral trade balance with Japan that's negative for quite a little while, if we can pick up more on exports to other countries.

Representative RICHMOND. Providing they would buy goods from us which had some type of labor——

Mr. Fox. We could have more of that growth in the developing countries, if there were a more reasonable exchange rate.

Represenative RICHMOND. I want them to buy our leather not our hides. I want them to buy our chickens not our soybeans. In other words, I want them to allow us to put a few dollars worth of American labor into what we ship them, and they won't. They buy our phosphates, but they won't buy our fertilizer. They buy our logs; they won't buy our lumber. One of these days the American people are going to understand how we're being taken, and all of a sudden, the American people will stop buying Japanese goods. They're more than capable of it. They did it once. They can do it again.

Last but not least, Professor Branson.

Mr. BRANSON. I agree with Fred Bergsten's analysis of the European situation. I think that's an area in industrial decline, and I don't see a way out.

Representative RICHMOND. I'm inclined to agree with you.

I have learned more this morning than I have in an awful lot of mornings. You're a terrific panel. Thank you very much.

The commitee recessed.

[Whereupon, at 12:40 p.m., the committee recessed, to reconvene tomorrow at 9:30 a.m., Thursday, May 27, 1982.]

VERSAILLES SUMMIT AND THE WORLD ECONOMY: HIGH INTEREST RATES AND PROTECTIONISM

THURSDAY, MAY 27, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m., in room 2175, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Betty Maddox, assistant director for administration; and Sandra Masur, Kent H. Hughes, and Marian Malashevich, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order.

A further hearing on the U.S. international economic relations.

The American economy has come to depend importantly on growth in the developing countries. Such growth in turn depends on the commitment of industrial countries to foster a climate in which development can flourish.

We sell over 30 percent of our exports to nonoil developing countries. Nearly one-half million Americans are employed in production of manufactured goods for export to these countries, and the harvests from one in every four American farms will go to them. In addition, the developing world is an important and sometimes crucial source of imports. Many of our manufacturing industries would collapse without their raw materials.

Accordingly, it behooves us, on the eve of the Versailles summit, to take a careful look at the economic policies of the Reagan administration as they relate to the Third World—both the impact of their macropolicies, as well as their commitment to development assistance.

The effects of the Reagan administration's macropolicies on the LDC's have been devastating. Continued high interest rates have added alarmingly to the LDC's debt burden, with each percentage point increase costing LDC's over $1 billion per year. In addition, the recession in the West has squeezed LDC manufactures and raw material exports, drying up their source of hard currency for needed imports.

The result has been curtailment of development plans and adoption of contractionary policies, creating difficulties ahead for many.

Compounding the problems have been the development assistance policies of the Reagan administration:

The emphasis of our foreign assistance program is shifting increasingly toward security and away from traditional development assistance;

A Treasury report on the multilateral development banks, while conceding their effectiveness and benefits, calls for phasing out public financing of hard-loan windows;

The International Development Association had to trim its fiscal year 1982 soft lending program by almost one quarter, due to administration cutbacks;

The administration rejected international calls for a separate World Bank energy affiliate to spur energy investment in LDC's; and

Secretary Regan has stated publicly that he sees no need for any IMF quota increase at a time when balance of payments financing and implementation of sound adjustment policies are more critical than ever.

Our witnesses today will be focusing on the prospects for developing countries in the current international economic environment, and on the impact of the Reagan administration's policies on these prospects.

Assistant Secretary for Economic Affairs Robert Hormats is the focal point for administration preparations for the summit. He will provide us with an overview of the administration's assessment of Versailles.

After Mr. Hormats, who has a later date with the Foreign Affairs Committee—we're so greatful to him for making himself available here today—we will hear from:

Lawrence Klein, 1980 Nobel laureat in economics, and a professor from the Wharton School of the University of Pennsylvania;

John Sewell, president of the Overseas Development Council; and

Ed Fried, a senior fellow at the Brookings Institute, and former U.S. executive director at the World Bank.

Mr. Hormats, we thank you for your prepared statement, which will be received in full. And I would now ask you to proceed.

STATEMENT OF ROBERT D. HORMATS, ASSISTANT SECRETARY OF STATE FOR ECONOMIC AND BUSINESS AFFAIRS

Mr. HORMATS. Thank you, Mr. Chairman.

First of all, I would like to say that in calling this series of hearings, you have undertaken what I believe to be a very constructive and useful inquiry. I gather that over the last several days, you have looked at a number of aspects, both short term and long term, of U.S. international economic policy.

I would like to take the opportunity here to discuss the approach that the administration is taking to the question of Versailles, and then I would be delighted, of course, to answer any questions you have on the issues that you are going to cover today, which relate to the developing countries.

Before discussing the detailed issues for consideration at the Versailles summit, I would like to review a bit of the history of economic summits, to put them in a broader context.

French President Giscard D'Estaing called for a meeting of heads of state of the major industrialized countries in 1975. It's useful to recall the situation of the international economy in the immediately preceding period. During the 5 years from 1970 to 1975, the world economy experienced:

The trauma of Vietnam, which strained traditionally close political relations between the United States and Western Europe;

Abandonment of the Bretton Woods parity system and great uncertainty about new arrangements;

Highly unstable commodity prices, in which food and raw material prices soared to record heights;

Quadrupling of energy prices, which not only strained the productive structure of industrialized countries, but created massive imbalances in global payments;

Major pressures on the international trading system, resulting from these imbalances and efforts of countries to offset them; and

Serious doubt as to the capability of the international financial system to cope with the requisite recycling of OPEC surpluses.

In sum, the international economic system was battered. There was widespread questioning of international institutions and of the ability of the major western countries to restore order.

It was in this setting that the first summit was held. Its objectives were to reassure the peoples of the West that their leaders could successfully grapple with the severe problems facing the world economy. It stressed the value of consultation and common effort in dealing with these problems.

It was not a new international decisionmaking body, but rather was designed to reinforce international institutions, a commitment to close cooperation, and the need to avoid attempts by companies to solve problems at one another's expense.

In the intervening years, summits have strengthened common efforts in several areas:

Resisting protectionist pressures;

Reducing dependence on oil imports;

Supporting constructive relations with developing nations; and

Setting a firm anti-inflationary course after the 1979 oil shock.

Despite progress in several areas, serious problems remain. At Versailles, the legacy of inflation from the 1970's will still be a major consideration. In the United States, in Europe, and in Canada, unemployment is at record levels for the postwar period. The inability of young people to find their first job continues to disillusion an entire generation.

In the international economy, there is widespread questioning of the fairness and adequacy of the trade and investment rules, and doubt has been raised whether the trading system, which over the past three decades has increased trading opportunities and led to the most rapid growth in world trade ever experienced, can effectively serve the needs of the decades ahead.

The currently soft energy market threatens to make us complacent and to cause us to let down our guard. It distracts us from the still-urgent need to assure energy supplies necessary for our security and adequate for a full recovery.

This is a complex and difficult situation. There is no quick or easy solution. Both here and abroad, many are tempted to turn inward to try to solve their problems by:

Increased protection or subsidies;

Erratic changes in policy which may have short-term benefits but long-term costs;

Concentrating on the faults of others, rather than applying their efforts to needed domestic actions, such as increasing productive investment and the capacity of economies to adjust to new competitive challenges and opportunities;

Avoiding or circumventing international institutions, rather than making efforts to strengthen and improve them.

Following World War II, the United States and its major Western partners recognized that economic recovery in Europe and Japan, and the future prosperity of the West, required close cooperation to build an international economic system which increased opportunities for trade and investment. Each recognized that its own economic growth, while depending first and foremost on sound domestic policies, also required a well-functioning international economy.

The IMF, World Bank, GATT, European Community, and OECD stand as living monuments to the wisdom and leadership of Marshall, Monnet, Acheson, Spaak, and others. They permitted and brought about a steadily opening international economy, which gave an enormous boost to trade and in turn, to jobs in the United States and in other nations. The prosperity of the postwar period owes much to these institutions, which too frequently we tend today to take for granted.

Today, however, there are pressures in this country and in others to disengage from a system which sometimes seems cumbersome, unresponsive, or unfair, and to adopt a more introspective international posture.

Let's face it. There are serious problems before our economies, individually and collectively. We as a nation must address these forthrightly, by strengthening our domestic economy, by actively pursuing our interests internationally, and by insuring a common multilateral effort to improve those institutions on which, despite their problems, we still depend, and in which we still have a vital interest.

Our prosperity depends on our willingness and ability to defend America's interest in and within a well-functioning world economy.

There are those in this country, as in others, who counsel disengagement from the institutions and rules which make up the world economy. They tend to forget the tragic lessons of the interwar period. But there are others who, I believe, remain in the majority and most countries, who recognize that, while we have high unemployment and inflation today, a breakdown in the international economic system and a move to protectionism would seriously worsen both of these problems.

I profoundly share that view.

But while urging a rejection of pressures for unilateral solutions, and in order to remain credible in doing so, we must correct the problems which give rise to them. To this end, the leadership of the United States is essential.

We remain the world's major economy and the political and security leader of the West. But, unlike the period immediately following World War II, we share economic influence with other countries, and our ability to play a constructive role depends on our ability to insure a partnership of shared responsibility with other major economies.

That is what the Versailles summit is all about. It's a historic opportunity to identify areas for common action to strengthen the world economy, both in the interest of our own nations and that of the many other nations who look to us for responsible leadership.

I will mention but two of the areas in which we hope to make progress in Versailles.

First, on macroeconomic and international monetary policies, we will work to reinforce international consultations among the major economies. Through greater consultation, each country can frame its policies in a way which leads toward sustained, noninflationary economic growth in the medium term.

In the declaration of the first summit at Rambouillet, the major countries accepted a particular responsibility for the stability of the international monetary system.

Questions have, from time to time, been raised whether other countries are sufficiently sensitive to, or knowledgeable of, one another's concerns on problems of domestic economic policy, and how greater economic stability in the financial markets can be achieved. More frequent and more intense consultations can enable nations to encourage one another toward sound economic policies, and to understand better the impact of each of these policies on the other.

Second, on trade, we are desperately close to undoing the multilateral trading system. That system is at a crossroads; either we improve it and strengthen its capacity to resolve problems, or risk its deterioration.

The benefits of an open trading system have been demonstrated over the years, but for it to continue, our citizens must have confidence that it is working fairly and effectively.

There are important areas which are not adequately addressed by the GATT rules. The ministerial meeting of the GATT this fall is an historic opportunity to address the trade issues of the 1980's. We will seek at Versailles not only a strong endorsement of the value of the multilateral trading system, but also a commitment to make concrete progress at the GATT Ministerial, to begin the effort to strengthen the GATT and to insure that its rules cover new areas, such as services, high technology, and trade related investment issues.

I will conclude my introductory remarks here, Mr. Chairman, but look forward to a wide ranging discussion based on your and your colleagues' questions.

Thank you very much.

HIGH U.S. INTEREST RATE REPERCUSSIONS

Representative REUSS. Mr. Hormats, the previous witnesses have been testifying that the high interest rates with the resulting strong dollar have had bad repercussions on our friends around the world; it forces many developed countries to support their currencies through higher interest rates, and that in turn leads to recessions there.

There are also negative high interest rate repercussions on the less developed countries.

Do you agree that our high interest rate structure has hurt the rest of the world?

Mr. HORMATS. First, high interest rates in this country have been harmful to our own economy, and we are not going to be able to get a sustained recovery in this country while interest rates remain high.

Second, internationally, the impact differs from country to country. It is probably true that for certain countries the real rate of interest is higher because the interest rate is relatively high.

I think in particular that's the case in Germany and Canada, where one could make an argument that the interest rate on deutsche mark denominated assets is somewhat higher than it otherwise would be.

With respect to a number of other countries, France being a good example, the interest rates are more related to the fact that the expectations in currency markets are for less progress in the war against inflation than in some other countries.

In short, the impact of high U.S. interest rates is mixed. It does have an impact on some countries; in other countries the high interest rate is more related to the market's assessment of domestic policies within those countries.

Representative REUSS. For those of our partners at the Versailles Summit who have felt what they perceive to be an unfavorable impact as a result of our high interest rates, do you expect them to sound off about it at the summit, or do you expect that they will do what they did at Ottawa a year ago? That is, remain agreeably supine about it all?

Mr. HORMATS. I expect that they will raise it. But in most of these meetings that I have witnessed, the general approach is not for one country to point the finger at the other.

I do think each tends to be willing to give advice—not acrimoniously put, but advice nonetheless—on various policy issues. And it wouldn't surprise me if one or two countries would raise this.

I don't think it would be raised in an acrimonious way or a combative way, but more in terms of trying to draw the implications, as they see them, of policies or interest rates in this country for their own economies.

Representative REUSS. The European Community recently invoked article 23 of GATT against the Japanese alleging that the Japanese acted in a manner that has prevented the Europeans from obtaining the reciprocal benefits from trade negotiations that they had come to expect.

Do you share the European view of the impact of the Japanese on Europe, and what about article 23 as it relates to the United States? Should we join the Europeans in their complaint?

Mr. HORMATS. I do think that a number of practices that seem built into the Japanese economy do tend to restrict access of foreign suppliers to the Japanese market.

We, the Europeans, the Canadians, and others, including developing countries, who want to export to Japan constantly come up against either overt barriers such as quotas on agricultural products or testing arrangements which take a very long time and are very cumbersome and rigid, or customs procedures which tend to be overly harsh and overly rigid.

I think by and large the Japanese economy is still for a whole host of reasons a relatively restricted market.

The Europeans feel frustrated, one, about their ability to get into the Japanese market, and two, about the fact that the European economies have not adjusted as rapidly as desired to new international competitive forces. And that is due in part to a number of rigidities in their own economies.

It is difficult to say at this time whether article 23 is the right way of doing it or whether it is better to pursue it bilaterally, but there is a strong case to be made for the Japanese opening up their economy and giving all of its trading partners access equivalent to the access which those trading partners give to Japanese products.

I can see the European frustration because we feel it ourselves. The Japanese have announced and are going to be explaining to us today the details of a new trade package. From what we are able to tell, there are a number of positive elements in that trade package, although we don't have the details.

But I do think the Japanese have more of a stake than any other country in the world in an open trading system and have to shoulder their share of responsibility for the system by opening up their own markets. That's what we have been aiming at, as have the Europeans.

Representative REUSS. Operating with much more bite, at least upon the United States, is not the churlish refusal of our Japanese friends to let our agricultural and manufactured goods into Japan, but their overwhelming of the market, particularly in this country with their hyped-up exports. That of course is the leading single factor in the great rash of protectionist suggestions which you have referred to continuing.

A number of witnesses see the relatively low-exchange value of the yen as contributing to this Japanese wrenching of world markets.

What do you have to say about the current valuation of the yen? Do you agree with the other witnesses that it is too low and it would do better for the rest of the world if it were to be revalued upwards somewhat? How would you go about that?

Mr. HORMATS. I think that the yen-dollar relationship has contributed to the ability of the Japanese substantially to increase imports into the United States, although it is not the only reason. I have a chart here, which I can give the committee afterwards, which demonstrates the strengthening of the dollar vis-a-vis the yen over a period of time.

Here the dollar is relatively weak and here it is a little stronger, but even during times when the dollar has been somewhat weaker vis-a-vis the yen, there still have been major surges in Japanese exports.

But I do think the yen is an important contributing factor—there's no doubt about that—because it does enhance the competitiveness of Japanese products in our market and in others.

Now, how to get the yen up? There is no evidence that the Japanese are intervening to suppress the value of the yen, as has traditionally been the case when countries want to hold down the value of their currency.

There's a lot of evidence that the Japanese have a very cumbersome series of capital controls, and those capital controls one way or another distort the value of the yen.

There's a debate in the academic community as to what happens if you remove those capital controls. There are those who say, initially people will borrow yen, buy dollars with the yen, and that will in effect weaken the yen vis-a-vis the dollar.

That's one school of thought. There's another school of thought which says that if you open up the Japanese yen market and have more and more people able to get into it, you have a lot more transactions done in yen. And the Japanese trading companies will use yen and American trading companies and others will use yen, and you will create a greater demand simply because of greater access to it.

I tend to think that whatever the outcome, a more open Japanese capital market would be desirable. I think there's one element that's particularly important there; one reason the Japanese are able to do well is that they have a target industry policy, under which certain industries get preferential access to capital because the banks are encouraged to provide that.

Now if you open up the Japanese capital markets so that an American firm can borrow on the same terms as a Japanese firm, you reduce to a degree the advantage which the Japanese firm might have through preferred access to capital. So that's an added benefit.

Over the longer term a more open Japanese capital market is going to insure that the yen comes to a more market-oriented rate. It may take a little longer, but it will do it.

Representative REUSS. Is it the policy of the American Government that the Japanese capital markets should be opened up so that, among other things, American borrowers can borrow on terms equivalent to the Japanese? Will this position be included at Versailles?

Mr. HORMATS. Yes, sir. We have made this point most recently. There was a meeting of the four trade ministers: Ambassador Brock and Minister Abe of Japan, Minister Lumley of Canada, Vice President Haferkamp of the Community; I participated in that.

At that meeting we made very clear that we thought this was an important element of the overall opening of the Japanese economy that we were seeking, and although I haven't seen the details—I gather there is a financial element in the package that the Japanese are going to be putting to us today.

So we do regard that as a very important element.

ENTERING JAPANESE MARKETS DIFFICULT

Representative REUSS. Perhaps it would be useful if you now laid out on the table the United States position vis-a-vis Japan economically in its totality; how do we get into Japanese markets? Even more importantly, how do we keep Japanese invasion of our domestic American markets to a level which is consistent with the Manchester School Economics that doesn't result in heavy American job losses? You say that the Japanese ought to loosen up their domestic money and credit markets so that others may borrow on terms equal to them. That's our position in this country.

Mr. HORMATS. Exactly. Today a foreign firm can come into the United States and borrow in New York on the same terms that an American firm can borrow. I think what we really want is equivalent access.

Representative REUSS. So that's point 1.

JAPANESE CUSTOMS

Mr. HORMATS. That's point 1.

Two, these are not necessarily in order of priority—but we have strongly urged a major improvement in the customs and the testing processes for getting into the Japanese market. They are currently cumbersome and very rigid.

CUTTING TARIFFS

Three, we would like a major cutting of tariffs. Tariffs are not the most critical factor, but they are still important in a number of products, particularly high-technology products, semiconductors, and such things.

AGRICULTURAL QUOTAS

Four, we have been urging them for some time to liberalize their quotas on agricultural products, which they argued they must retain for domestic and political reasons. These are the sorts of things we've been talking about.

RESEARCH AND DEVELOPMENT

And five, we would like to get access to the research and development which goes on in Japan on basically the same terms that Japanese firms or others have access to the results of our research and development.

One of the very interesting phenomena over the last decade or two is that most of the primary research in the world has been done in the United States.

Bell Labs is a good example of one of the leaders in primary research. In many cases that research is published. Indeed, foreign scholars and technicians can participate.

Very recently in Europe and Japan there has been an effort to do a lot more primary research on their own. Sometimes in Japan, sponsored by MITI. What we would like is the same openness of access to the results of that research, and the ability to participate in that research that others have in the United States.

That is particularly important as they do more in their area, because a lot of their innovations are piggybacked off our research; we'd like to do the same.

In the high-technology area that's going to be extremely important in the decade ahead.

Now, what can we do ourselves? It seems to me, to be very candid, one of the problems we have is that our approach to international trade is in some areas, at least, somewhat outmoded.

UPDATE ANTITRUST LEGISLATION

We still have antitrust laws which were developed in a period of time when the major competition for an American firm was another American firm.

Today in many cases, the major competition for an American firm is a foreign firm or a foreign group of firms. And, in part, our antitrust legislation may be—or needs to be—examined to determine whether it really promotes competition or whether it constrains competition.

REFORM EDUCATIONAL SYSTEM

Second, we need to do more in our educational system in training people to deal with the new technologies of the 1980's.

Japan is turning out more engineers than the United States today with half the population. As a result, we are going to fall further and further behind unless we can deal with some of these things.

EXPORT TRADING CORPORATION LEGISLATION

In addition, there are things like export trading companies; there's been legislation in the Congress for a number of years. It hasn't been passed.

Representative REUSS. Export trading companies?

Mr. HORMATS. Yes, export trading corporation legislation, which has been hung up in Congress for a variety of reasons which have differed from time to time for a number of years.

This is a great opportunity to enable us to have export trading companies similar to those of the Japanese. And absent that, we operate with one hand tied behind our backs, particularly the smaller and medium-size companies.

NEED FOR U.S. INNOVATION

There are a lot of things we can do ourselves. And getting back to your earlier question about the Europeans, which I thought was a particularly important point that you were making—if you look at the Europeans and to a degree, the United States, we have not adjusted to new competitive opportunities as quickly as the Japanese for a number of reasons. The Japanese have been very quick to take advantage of new opportunities. They innovate very quickly; process technology is done very well.

We can do it. We can do it in the United States. We invented robots, the Japanese applied them. But they were invented here. Almost all the really new technologies of the 1960's and 1970's came from the United States, and there's no reason why we can't compete in the 1980's if our economy gets going. If we get more investment, if we train the people we need, if we take a look at the laws which inhibit exports and inhibit certain collaboration among American firms—we can compete with them.

They're not miracle workers; they've just done things well. They're like Vince Lombardi, they do it well. They do it simply and they do it well.

Representative REUSS. I think you mentioned nine things—five of the Japanese, four that we can do—all of which I find commendable.

But I ask you, what do they do for the unemployed auto worker in Detroit or the unemployed television worker in Chicago?

This list of five and four of yours relates mainly to our getting exports into Japan, which is noble, but that isn't really, quite honestly, what is causing the milling around in the streets of America today.

I don't find exporters desperate because they can't sell in Tokyo. But I do find, as you know, a great protectionist impulse comes from unemployed workers and leading American companies who are hurt by Japanese large-scale absorption in the American domestic market.

Mr. HORMATS. I think you're absolutely right. It seems to me, as I indicated in my testimony, that the primary problem that affects many countries—you hear of it in Western Europe, and, of course, you hear it here, particularly in Detroit, the Midwest, and other parts of the country—is that we do have a very high—historically high—rate of unemployment. And that relates to or derives from a slow economy.

In addition—and this is the point I was really trying to get at—by improving our own competitiveness we would not only export more to Japan but also increase our ability to compete more effectively within our own market. In many areas we can beat them in the American market.

We do have a tragic problem, and that is high levels of unemployment. And I would say it's a hard point to make, because it's a tragic one. In certain industries recovery will bring about increased employment. There's no doubt about that. But in part, recovery in certain industries is going to be based on developing or introducing new technologies, which could well substitute capital for employment.

In the Japanese auto industry, there's an interesting example. A lot of the productivity in the Japanese auto industry is based on the use of robotics, which displace people in the auto industry.

Now, it's true that what happens is those people get employed in the robotics industry perhaps or other industries, but there's a very difficult human problem in making that transition, if it can be made at all. And I don't claim to have any miracle answer for how to deal with that problem when we do get recovery in the U.S. economy.

Representative REUSS. One big difficulty I have is that we seem to have a miracle nonanswer to the problem of energizing American technology by reason of the economic program now in place.

There are envisaged a combination of huge increases in military spending, largely hardware, which detracts from nonmilitary productivity in R&D and huge increases in revenue reductions as a result of the outyear tax program. This leads, as everyone knows, to a series of deficits ahead, which, in turn, leads to terribly high interest rates, which, in turn, leads to the situation we find ourselves in, whereby businessmen are not investing in the great new world.

So the unemployed workers we are talking about can't really be fed the line that they should wait for a few months until we start doing these great things, because as all can see, whether Wall Street or Main Street, it isn't working.

So what are we to do for these displaced Americans meanwhile?

Mr. HORMATS. Well, I'm getting a little out of my depth and the State Department has been accused of getting on to other people's turf too frequently.

Representative REUSS. But you're a big man, and it's all a seamless web to you.

Mr. HORMATS. As I say, the point I was trying to make earlier is that even if we do get a relatively robust recovery, there is still that problem on which you are touching. And that is structural unemployment, which is one of the great tragedies.

It's two things. One, it's unemployment among younger people, particularly among minority groups. It is very high and has been with us for a number of years.

I, quite frankly, don't have enough expertise to know the answer to that, although it is not only an economic problem, but a tragic social problem.

Second, you've got the question of what you do in an industry which needs more capital equipment to strengthen its productivity. And that capital equipment could come in part at the cost of jobs.

I don't necessarily claim to come here, as a representative of the State Department, having any answers to how to deal with either of those. I suspect that when you get domestic economic specialists, they will be able to give you a more specific answer.

Representative REUSS. Let me put to you a number of specific propositions that have surfaced during the course of our hearing, generally designed or at least proclaimed as cutting down on the volume of Japanese imports to this country in a way or in ways that are more or less free from impurities. In listing them, I don't mean to say that I endorse any or all of them.

It is urged, one, that we request at Versailles and other places, that the Japanese limit their investment abroad; the theory being that if they do that, keep their capital at home, the yen will strengthen, and thus the landed price of their exports will go up and they won't get the present unfair advantage over us and other countries because their currency will not be grossly undervalued.

I myself see some difficulties with that, but let's hear from you. Is that part of our policy package?

Mr. HORMATS. No, it isn't. And I share in seeing a lot of difficulties with it. I haven't studied this particular proposal in great detail, but what would happen is that if you kept the capital at home, you would more likely see that in order to lend, the Japanese would simply lower interest rates that they charged their companies.

Representative REUSS. If you accompany that with your commendable all-line-up-at-the-teller's-window-in-Japan policy, then you would vitiate that?

Mr. HORMATS. The two are inconsistent if you want to keep the capital at home.

What I want to do is not keep the capital at home, but let Americans borrow on the same terms as Japanese. So, I think that proposal is not one we're going to suggest at Versailles or, in my judgment, anywhere else.

Representative REUSS. I agree with you, it isn't just American borrowing. Far from having any objections to Japanese investment in job-creating activities in this country, I favor it. And if you say they can't invest abroad, you'd be cutting off your nose to spite your face.

Mr. HORMATS. Exactly. We want them to invest in job-producing enterprises here. That will deal with the unemployment problem. There's a concern in some sectors that if they invest, they'll simply

compete with more traditional American firms. But that's a separate but related problem.

But generally, if there's new investment which creates new jobs, we're not going to stand up and block it.

JAPANESE EXPORT CREDIT SUBSIDIES

Representative REUSS. Now, let me put to you another proposal. I think there is much to be said for this one, but I'd like your view. It does seem out of order to me for the Japanese to be using export-inducing, Eximbank-like subsidies, credit subsidies for export sales.

It seems to me that, in view of the great success that the Japanese are enjoying in exports, and particularly in view of the fact that the yen, for many reasons, seems to be undervalued, and that until the situation changes, the Japanese simply should not be giving credit subsidies for exports. They ought to be formally asked to knock it off—no more MITI, no more finance ministry, no more whatever other equivalent effects they've got.

Mr. HORMATS. I think, on the question of export subsidies through Government financing and Government credits, I couldn't agree with you more.

With respect to this we have made a major effort in the last round of OECD negotiations on official export credits to get the Japanese and, indeed, to get other countries to raise the interest rates that they charge closer to market rates; and in particular, the Japanese, as part of that package, agreed to add a certain amount of interest on top of their normal market interest rates in order to bring them closer to what we consider to be equitable levels.

Now, I don't think we're going to be able to get them to cut out their equivalent to the Eximbank program. But I do think that we haven't exercised our legitimate right to encourage them to insure that they do not provide credits at less than market rates, because that is a distortion.

And one of the things we are worried about internationally—and I know you are, Mr. Chairman—is that a lot of countries are providing export credits at less than market rates. What that does, it calls their taxpayers into the game, and it means our people are having to compete with exports of other countries subsidized by the taxpayers and treasuries of these countries.

Representative REUSS. I think we have to distinguish between our general motion toward exports, credit subsidizing across-the-board disarmament, which is a worthy course we've been on without too great success for a number of years, and the specific problem of Japan. The Japanese problem is due in large measure to the hard work and good planning and commonsense which they apply to their industry, also aided by an advantageously undervalued yen. They are gobbling up markets at a ferocious rate. The Europeans are cutting that down by imposing very vigorous import quotas on Japan, which leaves us as the sole happy hunting ground for the export industries.

Honestly, I can't think of a more benign way, a less vicious and miserable way, of rectifying this as far as the United States is concerned than to say that the problem of Japanese export credit subsidies ought to be considered on an immediate basis, quite apart from the general push toward multilateral export credit subsidies.

Mr. HORMATS. I agree with that. What I said in the context of multilateral discussions, we have singled out the Japanese and asked them to do something above and beyond what the others have done.

I think your broader point though is absolutely right, that there is—inasmuch as the yen is relatively soft vis-a-vis the dollar, inasmuch as the Japanese are doing quite well—considerably less need for them to maintain a strong export-financing drive. And I do think it's desirable for us to make the point strongly that if they don't need it and if it is disruptive, they shouldn't practice it. I agree with that.

Representative REUSS. Can you think of any better single position which we might take at Versailles designed to somewhat reduce the swelling of hyped-up Japanese exports to this country than to ask them, very promptly, to very markedly reduce or eliminate their export credit subsidies?

Mr. HORMATS. I think to the extent they have export credit subsidies, we certainly ought to insist that they eliminate them. I don't disagree with that at all.

And I think, as I mentioned earlier, the Japanese do have a financial element in this package.

And what I would like to do is get a look at what is in that package, to see if it addresses this. And if there is a measure of export subsidy remaining as a result of that package, following that package and following the OECD agreement, I think we ought to make a very strong push to get them to stop that. I agree with that.

Representative REUSS. When are you going to see this package? Tomorrow?

Mr. HORMATS. I think today.

Representative REUSS. If there is in that package a Robin Hood fellowlike jester on the part of the Japanese to cut out their export credit subsidies, grasp it to you with hooves of steel. And if there isn't, put it in there at Versailles.

Mr. HORMATS. I will be sure that if there is any export subsidy after we have gone through what they have done, we will put it to them clearly.

Representative REUSS. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Good morning, Mr. Secretary. It's always a pleasure to see you.

Mr. HORMATS. Good morning.

Representative RICHMOND. I heard your dialog with the chairman about the possibility of our requesting the Japanese to drop their export subsidies. I think we all have to realize that the financial situation in Japan is quite different from the financial situation in any other country in the world. Their interest rate is 5¾ percent, they have a surplus of cash, yet it still hasn't occurred to them that the best investment in the whole world for them is to take some of that cash and send it over to the United States and buy some of our ailing businesses—they have more money than they can possibly spend in Japan.

Now, whether you call it export subsidy or just long-term loan, how in these grand conversations at Versailles are we going to get the Japanese Ministry of Finance at the meeting to say that we won't let the Fuji Bank loan Fujitsu a trillion yen in order to expand their exports or in order to do whatever they want to do?

In other words, for us to have such things as Eximbank and assist Budd in upstate New York in selling subway cars to MTA is one thing, because interest rates are 16 percent plus, so we need that.

But in Japan, the whole financial system is an Eximbank. There's no way you're going to be able to tell the Fuji Bank not to extend ample credits to their clients to increase their business.

So, when you talk about telling the Japanese that they can't extend export credit, I think we're just talking nonsense.

Mr. HORMATS. I think earlier we were addressing this particular point. There's one point, which is the export credit subsidies, where I think we do have a legitimate right to tell them not to do it. There is a second point, which relates to the broader point you made, and I tend to agree. The whole system is a sort of large Exim——

Representative RICHMOND. Export credit subsidy?

BORROWING IN JAPANESE MONEY AND CAPITAL MARKETS

Mr. HORMATS. Even beyond that, because of the target industry question. Capital goes to industries that the Government favors. Not always, but in many cases. And that enables them traditionally to get a relatively secure source of capital. Unlike our companies, particularly our high-tech companies, which have to rely heavily on equities, they, the Japanese firms, get a rather steady stream of capital even when, for a period of time, their profits are low for cyclical reasons or because they're putting a lot more in investment.

One point that I tried to make earlier is: We have been encouraging and pressing the Japanese to enable our companies to borrow on the same terms and conditions as Japanese companies, so that a Texas Instruments or a Burroughs or an IBM can go in and borrow on the same terms as Fujitsu; just as Fujitsu can come to New York and borrow on the same terms as TI.

Representative RICHMOND. As a practical matter, can our American companies who have Japanese factories abroad, borrow money from Japanese banks?

Mr. HORMATS. Can they do it? Some, in a limited way, have done it. It's parceled out in a very regulated way.

Representative RICHMOND. Mr. Secretary, if we can get that straightened out, I think it would be a lot better than this export-import thing.

Mr. HORMATS. Absolutely.

Representative RICHMOND. As I just mentioned, in effect, there's no such thing as export-import grants in Japan.

Mr. HORMATS. I think both are important. One, they shouldn't be subsidizing export credits——

Representative RICHMOND. They're not subsidizing export credits. What they're doing is lending money at 5.75 percent, which is their standard interest rate.

Mr. HORMATS. The Chairman raised the point, are there export subsidies? I was saying, to the extent there are, we should argue to get rid of them.

I think the broader point—we had discussed that earlier—is the way their target industry operation works; we want to insure that our firms can borrow on the same conditions and terms as their firms. That would

help to deal with the target industry problem, and would help to deal with the other larger issues that we've been talking about.

As a matter of fact, I pointed out earlier that we made this point to Minister Abe in earlier discussions, and that he had indicated that he understood the point. And my judgment is that he was going to go back and at least make an effort to try to deal with it. But we haven't seen that. We're going to get the package—we're going to get the package today and we'll get a better sense of what's in it.

Representative RICHMOND. I think if we called a spade a spade here, we'd be so much better off.

We can't ask the Japanese to stop their export subsidies, because then any long-term loan any Japanese bank gives to one of its clients—manufacturers—is in effect an export subsidy.

Now, if we demand that Japanese banks give the same service to American companies that are based in Japan, like IBM—in other words, IBM should be able to borrow money at the same rate at which Nissan Electric can borrow it. That I consider fair, because as you say, Nissan Electric Co. or Sony does business in New York and borrows money here.

Mr. HORMATS. Yes. And that is the point that I made as recently as 2 weeks ago, in a conversation with Minister Abe.

Representative RICHMOND. What did he say?

Mr. HORMATS. He understood the point. And I think the reaction that I got from him was a positive one: That he understood and he would try to do something about it. I can't guarantee what's in the package, but I do think that he is going to go back and make an effort to do it. We will see what happens.

Representative RICHMOND. I wish you luck. Thank you.

Mr. HORMATS. We need luck.

Representative REUSS. Mr. Secretary, in my opening statement I talked about development assistance, and made the point that our high interest rate policy has produced devastation in a number of ways, for the developing countries. Then I went on to list a number of specific policy stances by the administration which, in my view, are wrong-headed and hurt the LDC's.

LDC POLICY

Let me recapitulate them and have you tell me, if such is your view, why you think I'm mistaken.

One, we are shifting our foreign assistance program away from economic and development assistance, and toward military security in a way that is going to hurt development.

Two, we have called for the phasing out of financing from the hard loan windows, toward middle-level LDC's in the multilateral development banks.

Three, we have cut back—with congressional acquiescence, I must admit—on our aid to the International Development Association.

Four, we have rejected the World Bank's proposed energy affiliate.

And five, we are opposing the IMF quota increase at a time when balance of payments financing needs are very strong.

Would you address those five criticisms which I make of our LDC policy?

Mr. HORMATS. OK. First, let me make a general observation on this, because I think it might help to put some of these in context. I think you've asked very valid questions, and I will try to address them one by one.

But basically, it seems to me that the development approach in the latter part of the 1970's and the decade of the 1980's has to be somewhat different from that in the 1950's and 1960's and the early part of the 1970's. That is, aid remains critically important. There is no doubt it remains critically important to the poorer countries of the world.

They can't export very much to earn the money they need. In some cases, their commodity earnings are depressed as a result of high interest rates and low growth. A lot of the projects that they need involve health, education, and projects of that nature—water—which don't allow for borrowing on commercial terms or close to commercial terms.

There is a second group of countries which depend increasingly on their ability to attract foreign investment and the ability to export into developed-country markets. And from the point of view of those countries, open international investment and, very importantly, open markets in developed countries, are probably the critical elements in whether they succeed in the 1980's.

Many have borrowed very heavily, as you know, on the expectation that they will be able to export in order to repay the money they borrowed. A lot of countries in this hemisphere and east Asia fall into that category.

So that, in order to develop an approach to deal with development in the 1980's, you need a combination of aid, investment, and trade, similar to the sort of bundle of programs that was put forward in the Caribbean.

Now, on foreign assistance, there has been a major emphasis on the security assistance, in part because that is important in the overall effort to bring about a peace in the Middle East, or toward a peace in the Middle East; in part, because there were new pressures as a result of the Soviet invasion of Afghanistan—in that area of the world—to provide more security assistance.

And I think it's true that that has gotten more emphasis than, as you put it, "traditional development assistance."

With respect to the multilateral development banks, there has been a recognition of the fact that it's less likely now than in the past that we're going to get the sort of steady increases in multilateral funding that we had in the 1970's. And second, in order to get money out of the Congress and out of OMB, we had to demonstrate that countries that could move up the curve from softer to medium to harder terms were moving up that curve at a relatively expeditious rate.

Now, the one thing that is very important to note about that Treasury report is that it was agreed that those countries would not move at a faster rate than their creditworthiness permitted.

And I think that there is merit in keeping, even in countries at the very high end of the spectrum, some presence by the World Bank, largely because when you go to these countries, they will indicate that they value very much the technical support, the advice, the wisdom about development that they can get from the World Bank.

So, the basic approach is not a wrenching adjustment, but a more gradual approach, which is consistent with the creditworthiness of those countries. And that some of the soft countries would move to medium terms or mixed credits, or "blend" as they call it, and other blend countries would move up to harder terms, and ultimately rely, as some countries now do in the developing world, very heavily on private borrowing. But it's not supposed to be a wrenching adjustment.

Third, I would make the same point on IDA that you made. And that is: That the administration did, in its request, ask for sufficient funds to meet our obligations on time, with a sort of stepup increase. And we found that it was difficult to get that through the Congress, so we have now had to go to 4-year replenishment rather than 3-year replenishment.

And what you say is happening. That is, because there is a formula in IDA which calls for prorating of contributions, a number of donor countries have cut back and are going to increase their contributions in the same sort of stepup way that we will.

With respect to the World Bank energy affiliate, that was an idea which I think, in its time, had a greater degree of acceptance internationally than it does now.

The premise upon which that was based was that it would be a new pool of money, and that the OPEC countries would provide a very large share of that pool, larger than their share of IDA contributions.

Subsequent to the initial discussion of that, the price of oil has gone down. The OPEC countries collectively now are not even in surplus. And as a result, the enthusiasm for providing a disproportionately large share has now all but evaporated.

There are a few OPEC countries who still like the idea, but say they would provide the same share to this as they provide to IDA or the Bank. So, I think for the most part, that is not going anywhere.

That is not to say that the World Bank shouldn't have an important role—indeed, perhaps a growing role—in energy production of the developing countries. Because in many developing countries, that is still the single largest bottleneck to their development. And we have been encouraging the World Bank to play a greater role, but we don't think that the energy affiliate has got sufficient international support.

And we also think, quite frankly, Mr. Chairman, that given our lack of ability to get IDA through, it's going to be doubly hard to go up and get funding from this Congress or from OMB for a new institution.

Representative Reuss. The one thing in my list that you haven't commented on is our opposition to an IMF quota.

Mr. Hormats. Yes. Secretary Regan's point. Sorry. I haven't been intimately involved in every aspect of this. A lot of the discussion went on in Helsinki, when I was at a trade meeting, elsewhere, the one I mentioned to you earlier, with Minister Abe.

But basically, his view is that the real emphasis now ought to be on the adjustment of individual countries to reduce some of the structural imbalances. And this really ought to be the priority route that new funds channel through the IMF.

Representative REUSS. I know that you have another date up here on the Hill, and I just want to thank you very much and excuse you.

I would say, by way of comment on your answer to my criticisms of our current policy toward the less developed countries, that while it is true that Congress must bear at least part of the fault—if fault it be, as I think it is—nevertheless, as I'm sure you recognize, it's always going to be true, under Democratic or Republican administrations, that the Congress by itself is not going to be noble about foreign economic policy.

It takes an administration which is out in front and willing to perhaps incur momentary setbacks. That's the only way that the Marshall plan, point IV, development assistance, OECD, IMF, the World Bank, IDA, IFC, IDB, ADB, and so forth, ever got off the ground. So, it really won't do for any administration to say that Congress is pusillanimous, which is perfectly true, but known to every civics teacher in the land.

Mr. HORMATS. I wasn't placing the burden. I was just stating the facts with respect to that particular item.

Let me just say, to sum up, that the United States has taken the lead in the last 30 years in developing the sort of fundamental institutions which today make up the world economy. There are increasing pressures on those, internal and external.

I think if you look at the history of modern man, one can see that these are extremely constructive institutions, and the people who developed them were extremely enlightened and developed what was needed to make progress and keep unity in the world economy. And they have been the centerpiece of the effort to improve trade and increase international investment. And despite their problems, which occur from time to time and which we are all aware of, they have done extremely well. The World Bank and IDA have made excellent contributions to development. Without those institutions, the developing countries would be considerably worse off.

And, as your statement indicates, we would be worse off. We export today well over a third of our overall exports to the developing world. And in the future, these countries are going to be important markets, increasingly important markets, for our products.

I think that, while from time to time there may be problems with these multilateral institutions, we have a fundamental stake in them. I quite agree that there needs to be strong support, from the executive branch to maintain our commitment to the whole host of multilateral institutions, which are vitally important to our own prosperity.

I just would conclude on that theme. I'm in full agreement.

Representative REUSS. We're grateful for your testimony this morning, and I am personally most happy that you are where you are.

Thank you for being with us.

Mr. HORMATS. Thank you, Mr. Chairman.

Representative REUSS. We'll now hear from a panel consisting of Messrs. Lawrence Klein, John Sewell, and Ed Fried.

Welcome, gentlemen. You have helped us much in the past, and I know you will this morning too. Your prepared statements will be incorporated in the record in full, without objection.

Would you now proceed, starting with Mr. Klein.

STATEMENT OF LAWRENCE R. KLEIN, PROFESSOR OF ECONOMICS, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. KLEIN. Thank you, Mr. Chairman. Today, as I understand it, we are to focus attention on problems of the developing countries, and I have a statement which I will read rather briefly.

The first part deals with the general world situation.

The world economy is in recession, and although some areas are poised for recovery, it is hard to find clear signs of a turn having occurred. It is a pervasive recession, and the developing world has not escaped many of its worst aspects.

The developing world is highly varied, and although the recession is generally evident everywhere, its impact has been uneven. At two extremes, we find continuing poor performance in Africa, especially in black Africa. There, food conditions are poor in a number of areas, and growth rates are at best 1 or 2 percent, while negative values are also discernible in a few places.

NEWLY INDUSTRIALIZED COUNTRIES HURT BY WORLD ECONOMIC CONDITIONS

The best of conditions, on the other hand, prevail in the Pacific Basin, but the seemingly high growth rates in some countries represent significant come downs. During the late 1970's some Pacific Basin countries were showing two-digit growth rates and the present figures of 6 to 8 percent may look high on a world scale, but they are considered mediocre in relation to past performance. A strong feature of the Pacific area countries has been their low rates of inflation. Malaysia and Singapore, for example, are rarities among developing countries because they have had inflation rates below 10 percent. Other countries in the Pacific have not been areas of high inflation, when viewed against the backstop of developing nations as a whole.

Latin America is showing an average growth performance but experiencing high inflation rates as usual. Chile and Argentina have known much worse times, as far as inflation is concerned, but other countries are now worsening, shifting from moderate inflation to becoming severe cases.

Last year, the Middle East did not measure up to the expectations that would be associated with a rich oil exporting area. The declines in world oil production were reflected in total output, GDP, decreases, not to mention the setbacks to production caused by war in Lebanon, Iraq, and Iran. Restraint in oil production will continue to have adverse effects on Middle East growth during 1982, but the nonoil sectors of the OPEC countries of the Middle East should continue to show progress, as integral parts of long-range development plans.

Overproduction and excessive inventory holdings have plagued activity in markets for oil and other primary commodities. On a year-over-year basis, it is estimated that world oil prices will show a decline of about 5 percent for this year. At the beginning of this year, primary products other than oil, registered a decline of about 12 percent. These soft prices have had serious impacts on export earnings of many developing countries who are important primary producers. A good part of the price decline can be attributed to the world recession, but in the case

of oil, conservation has also played a role. For some other primary products, substitutions have been made, which may hold back earnings even after recovery begins. This is all the more true if world recovery is, as expected, quite modest. World steel production, for example, may not regain its former preeminence as a heavy industry sector, and this could mean less than full optimism for the future of iron ore production.

In this recent setback for developing countries, a number of star performers, particularly among the newly industrialized countries, have been hit hard. As oil exporters, Mexico and Nigeria both implemented ambitious development programs. They borrowed funds at high interest rates because they were confident about the tendency of oil prices to rise indefinitely. Now they find themselves burdened with high interest costs and face joint declines in oil price and oil volume. In Mexico's case, it led to devaluation of the peso, very high rates of inflation, cutting back of development plans, and the need to borrow heavily on world capital markets.

Brazil moved down from high growth in 1980 at about 8 percent to negative growth in 1981, and poor prospects for the immediate future. There has been no letup in inflationary pressure. Brazil, like other newly industrialized countries, depends heavily on world markets for pursuing a policy of export-led growth and is not expected to recover the dynamic status of a star performer until the world recession ends and a definite recovery phase comes into place.

In the Pacific Basin, a great deal of attention has been placed on the "New Japans"—South Korea, Taiwan, Singapore, and Hong Kong. As we already indicated, these countries still look strong when compared with the rest of the world, but their ambitions are very high, and there is no doubt that they have been set back by the depressed world situation. If South Korean growth rates appear to be unusually impressive, it is to a large extent a case of rebound from the negative rates that followed the assassination of President Park in October 1979, the ensuing political uncertainty, and the imposition of martial law. Korea is apparently recovering, but we should not draw the misleading interpretation that all is well, from an economic point of view.

The newly industrialized countries have been considered to be excellent credit risks, but in today's environment we are finding enough surprises to realize that even the best of cases may have some underlying weaknesses. Mexico cannot simply assume that oil wealth solves all her economic problems in a single generation. Brazil, South Korea, and other countries who depend heavily on export markets cannot assume that foreign earnings are always going to be large enough to provide adequate debt service. At presently punitive interest rates they all stand to court trouble. It was not long ago that Polish officials and economic observers thought that their past record established them as prime credit risks, and their developments are not entirely different from those that might be expected to occur among newly industrialized countries.

NEGATIVE OPEC CURRENT ACCOUNT BALANCES

The most noteworthy economic tendency among developing countries this year is the swing in the current account status of the OPEC countries from strong surplus toward negative balances. The same is true of other oil exporting countries outside OPEC. This is not the first

time that OPEC nations have had to come to the world financial markets for net support. It happened between the first and second oil shock. The net gainers in this changed situation will be the oil importers among OECD countries, especially Germany and Japan.

The United States will benefit from the more favorable oil position, but our current account could deteriorate for other reasons. The oil importing developing countries will benefit, too, but they are having adverse trade impacts because of price declines in primary products other than oil.

The decline in oil prices could well be temporary. Some even believe that it is now ceasing, but if it is accomplished primarily by production controls, that situation does not look particularly favorable for export earnings.

A plausible projection is for a turnaround in oil price movements during 1982, lowering the year average; below the 1981 average but making 1983 average once again.

The rise is projected to be moderate, in line with the expected moderate recovery in the world economy, so that real oil prices will be lower in 1983 than in 1982. It will be 1984 before we can expect to see oil prices rising as fast as, or faster than, OECD export price expansion.

LOW WORLD GNP GROWTH

One, my next section deals with the world recovery. World GNP grew by only about 1.6 percent in 1981. In the industrialized countries, it was marginally worse, at about 1.4 percent. The centrally planned and developing countries are expected to show slightly better growth for 1982, while the industrial countries should do worse, pulled down especially by the U.S. recession, which carries a big weight in the total.

By 1983 and 1984, the world should be on a 4 percent recovery path. This may seem to be optimistic when placed alongside the dismal readings for this year, but it is actually a modest recovery, for the early period of a general pick-up should show faster-than-average growth.

If the OPEC countries stop cutting back oil production, they and the oil importers in the developing world could jointly grow at about 5 percent.

World inflation has been brought down by this recession; that was in fact the policy intent of the restrictive measures introduced by Great Britain, the United States, Germany, and many other industrial countries. Lower inflation rates should be helpful all around, for the developing as well as the industrial countries, but some areas of the developing world will experience worsening inflationary pressure.

Mexico's inflation rate, for example, is jumping from about 25 percent to 50 percent as a result of devaluation of the peso and subsequent wage increases.

DECLINE IN VOLUME OF WORLD TRADE

Concomitant with the world recession in production, there has been a corresponding decline in the volume of world trade. It was held to a virtual standstill in 1981, and is projected to expand this year by only 1.5 percent.

Thereafter it might grow by about 1 percentage point above the GDP growth rate, but this is a great comedown from the expansive period of the late 1960's when world trade was growing by about 10 percent annually.

This was a period when the Newly Industralized Countries benefited greatly from their participation in the expansion of world trade.

The developing world as a whole needs a strong world trade growth rate for their economies to prosper. Moderate recovery in production and world trade presently being forcasted will help the developing world but leave them far short of aspirations.

When modest trade expansion is coupled with high interest rates, reluctant world bankers who have been shaken up by poor loan experience, and tendencies toward protectionism by OECD countries, it is not surprising that developing countries need to reassess their economic policies.

For one thing, they need to work at becoming even more competitive than they have been in the past. Mexico needs to expand nonoil exports. Brazil needs to compete with other manufacturing nations in order to export goods other than coffee, cocoa, and iron ore on world markets.

SLOWDOWN IN PRODUCTIVITY

What are needed in order to remain cost effective are good increases in productivity, wage restraint, moderate profit margins, and effective changes in exchange rates.

For a while, the Newly Industralized Countries were enjoying strong gains in productivity, but after 1973 many developing countries were affected by the general slowdown in productivity and covered up problems in being competitive through the medium of exchange of depreciation.

This has induced inflationary feedbacks. While they must remain flexible in exchange rate policy, they should focus on more fundamental aspects of becoming competitive such as the encouragement of productivity gains.

NEWLY INDUSTRIALIZED NATIONS TARGETS OF PROTECTIONISM

Two, the final section deals with some current issues.

First, protectionism. While we hear a great deal about protectionist sentiments aimed at the Japanese invasion of markets in North America and Western Europe, the problem is much broader and exists as an obstacle to free trade between the developing and industrial worlds as wholes.

In particular, the Newly Industrialized Nations are collectively targets for protectionist barriers. We have already seen them in textiles, shoes, and TV sets.

There is nothing like good growth for the entire world economy and associated expansion of trade in order to stem the expanding tide of protectionism. The restrictive economic policies of the industrial nations are, at the base, responsible for conditions under which protectionist sentiment thrives, although such ideas have independent sources in mature countries who are having their own unusual problems of economic revitalization.

NORTH-SOUTH TRANSFERS

Three, the second issue is North-South transfers. The report of the Brandt Commission and other sentiments in favor of North-South capital transfers for the purpose of stimulating economic progress among the poorer developing nations have been cooly received among potential donor countries.

The future of North-South capital flows in the form of concessionary aid or transfers is not bright, and North-South economic problems are likely to remain intense as ever. In this cool environment it is important for developing countries to look elsewhere for betterment of their economic positions in life.

In this connection, the concept of increased South-South trade and, in general, South-South economic relationships are worth serious exploration.

Among developing nations there are simultaneously good bases for supply of primary materials and production of finished manufactures, at nearly all levels of technological sophistication.

If the developing nations involved can get together for the establishment of favorable trading and investing relationships, it is possible that they can short circuit the obstacles to growth that are presented by the slow-moving industrial nations.

At the same time that developing nations are being encouraged to promote South-South trading relationships, they can also be urged to look more carefully at their own domestic markets.

Some of the developing nations have large market potential at home and can get as much support for their own economic activities in the domestic market as in the world market.

MULTILATERALISM

Multilateral free trade and development promoted through multilateral agencies have been the hallmark of three decades of postwar development in which many developing countries have come a long way along the path of economic progress.

Now, they are faced with an American administration that favors bilateralism, especially with military undertones, and provides faint-hearted support for multilateral economic institutions in dealing with developing nations.

This is an unfortunate policy change as far as progress in the developing world is concerned, and we can only hope that it is temporary.

EXCHANGE RATE POLICY OF DEVELOPING COUNTRIES

Apart from the fact that developing countries have used exchange rate movements to compensate for laxity in domestic inflation, productivity growth and profit margins there is yet another aspect of exchange rate policy for developing countries that is relevant for present circumstances of the international economy.

It is often the practice of an individual developing country to tie its exchange rates to that of a particular industrial country. Many Latin American countries, for example, may tie their rates to the U.S. dollar.

It would be better and more flexible to tie rates to a combination of currencies, either well established institutional combinations such as the SDR or ECU or to tailored averages.

This would spread the risk of having some awkward ties. At the present time, for example, those countries tying their rates to the dollar are finding that exports are correspondingly over priced and hard to sell.

Combinations of currencies are less likely to be unusually over or understated than in any single currency. The whole subject of exchange rate determination is complicated, and we are just beginning to learn something about it for the major industrial countries who now have almost a decade of experience in living with a floating system.

It is a much more difficult challenge to undertake similar investigations for developing countries.

That concludes what I had to say this morning in my statement.

Representative REUSS. Thank you very much.

Mr. Fried.

STATEMENT OF EDWARD R. FRIED, SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. FRIED. Thank you, Mr. Chairman. I submitted a relatively brief prepared statement, which I would ask that you include in the record, and I will summarize my remarks even more briefly so as to maximize time for discussion.

MULTILATERAL DEVELOPMENT BANKS

I had focused on one subject, what might be done at first eye, in regard to the multilateral development banks.

I think the possibilities are three: First, that action could be taken to enable these banks to increase their lending at the present time generally.

Second, as a subset of this, to increase their lending for energy in particular; and third, to do something to restore IDA on its previous course; and to take action that would insure the continuation of this rather critical program as far as the developing countries are concerned.

Versailles could do a great deal to give a boost to each of these, but there seems to be little indication that North-South issues generally will receive any emphasis at the summit, and Bob Hormats' statement to you this morning is notable for the absence of these issues entirely.

Now, I think that as a backdrop you should look for a moment to what is happening to the current accounts in world payments:

DECLINING OPEC CURRENT ACCOUNT SURPLUS WILL LEAD TO SURPLUS FOR INDUSTRIAL COUNTRIES

As Larry Klein has pointed out, the OPEC surplus is rapidly disappearing. I think for 1982 it might amount to $25 billion and conceivably could be less, perhaps going to zero, but this is obviously a matter for conjection.

As a group the industrial countries' current account will be moving into surplus, and the current account of the current oil-importing developing countries will remain high, probably at something like $85 billion for this year—about the same in real terms as it was in 1980.

Now, we no longer have the issue of recycling the OPEC surplus. What we have now is the more traditional position of a surplus in the industrial countries and a deficit in the developing countries.

Now with this—I think the reason for the high deficit is fairly clear: The oil-price jump of 1979–80 added about $35 billion to the import burden of these countries, and that is going to go down very, very slowly.

Second, the recession in the industrial countries means soft markets for manufacturers, and weak demand as well as low prices for primary commodities. And third, the record high interest rates in the industrial world obviously increases the burden of the very large debt that already exists.

That's the reason that the surplus—that the deficit is remaining high and will go down only slowly.

What I think is not as much appreciated is that for the most part these countries have already done a great deal in the way of adjustment, in the way of belt tightening.

If you look at the oil-importing developing countries as a whole, the growth has been a respectable 4 percent or so—less certainly than it was in the period before 1973. But investment has been pretty much maintained and consumption as a share of GNP has been going down. This is belt tightening and this is adjustment, but more time will be needed.

Clearly, some countries have done much better; some not as much. But as I see it, the risk is that in this kind of situation, the commercial banks, fearful of the continuation of large deficits and of the high debt, will begin to cut back heavily on their loans to these countries.

I think on economic grounds this would largely be unwarranted, but this is the kind of concern that I think the international system should seek to guard against.

Now at present the banks are providing about $40 billion of new financing a year to these countries—roughly half of the financing for their total current account deficit.

But given this risk, I think it's all the more important now that the industrial countries—and particularly the governments represented at the summit—should be encouraging the World Bank and the regional banks not to cut back on their lendings, but to increase their lending just at this very time. Because it's this kind of lending that can add confidence to the commercial banks to continue what they are doing, and it's this kind of lending—being lending for projects that represents adjustment in its best forms—it represents the increase in production that eventually will make it possible for these countries as a whole to pay their own way.

ENERGY FINANCING

Now, one element in this kind of lending is clearly lending for energy. I have noted in my statement that energy is an integral part of the development process. Twenty years ago the developing countries used about 10 percent of the free world's commercial energy. Today

that's 15 percent. By the end of the century it will be 25 percent. As long as oil prices remain high, and I believe they will remain high through the end of this century, energy will be a consistent constraint on the economic growth of these countries, and one of the important areas of adjustment therefore, that these countries can take is to be able to increase investments both to increase domestic production of primary energy fuels—that's any kind of primary energy fuels, because in the end that backs out the demand for oil; and second, investment to increase the efficiency which energy is used.

Now, to the extent that this is done, this will help everybody. Clearly, it will help the world energy outlook and in this sense the industrial countries as well, because if you look ahead, the biggest—in fact, the only major source of increase of demand in the world oil market will be the increase in demand of imports of the oil import developing countries. Therefore, to the degree they can be contained, this will both assure that supplies will be more ample and more secure of everyone, including ourselves.

Second, the more these countries can do in energy, the less the strain will be on the international trade and financial system as a whole. At the moment, to do this a very large investment program would be required. The Bank has estimated this would be on the order of $40 billion a year over this decade in constant dollars, in 1980 dollars. This is a large amount. It's more than double what's been happening in these countries until recently.

The most important vehicle that we in the industrial world have to assist these countries to increase their production of energy and their efficient use of energy is the lending program of the World Bank. The Bank now in responding to this problem has greatly increased its lending for energy. Those loans this year will probably amount to over $3 billion, or over 25 percent of its total lending, and this is what the Bank proposes to continue to do over the next 5 years.

It also argues, and I believe rightly, that this is about the maximum it can do under present circumstances without jeopardizing other high-priority programs, food in particular. So what's needed is some means of increasing the Bank's ability or authority to increase its total lending which, as I said, would fit in with the first objective I noted. Such increase in lending would be useful at the present time, in terms of the total international financial system.

The bank believes that it can virtually double its present program if it had the lending authority, all for cost-effective projects with high economic rates of return. Now, one way of doing this that has been considered was the establishment of an energy affiliate. Whatever the merits of this, I believe it had merits, I believe it would have been useful to do, it's not practical now since the United States has opposed it. I don't think it's as Bob Hormats said because the OPEC countries would no longer be interested. At one time they certainly were, and it isn't simply the OPEC countries. It's only the few OPEC surplus countries, namely, Saudi Arabia, Kuwait, and perhaps the United Arab Emirates, and one or two more.

But in any event, I think the issue is academic, as long as the United States continues to oppose this. And that needn't be any serious setback. I think much the same objective could be accomplished if we were willing to allow the Bank now to increase its total lending, which

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could be done by the action of the major industrial countries. Simply lift the lending ceiling at the present enough to accommodate this increase in lending for energy that the Bank believes would be feasible and economic.

World Bank President Clausen has estimated that the Bank could lend $1 billion more this year, $2 billion more in 1983 and almost $4 billion more than it presently is able to do for projects that would have high economic rates of return. I think if we pushed for such a program, we could also ask the capital surplus oil OPEC countries, the Saudis in particular, to join with us in this kind of endeavor and at the same time to see that their lending for energy in these countries either in cofinancing Bank projects or otherwise, could also be accelerated to achieve this kind of objective.

Now, I think the important thing is that lifting these ceilings at the present time would not require additional budgetary appropriations now. What it would mean is that we would be advancing by, say, 1 year from 1985 to 1984 the time at which the next addition or the next capital increase for the World Bank would have to be considered. That would mean no budgetary appropriations until—new budgetary appropriations, until that time, in order to finance an expanded energy and Bank lending program in particular.

Now, at that time, when the next capital increase is considered, I think we should realize that that could be accomplished this time around without paid-in capital. This is an issue that is debatable, but certainly is, to my mind, at least a feasible proposition. So in thinking about increasing the Bank's lending program now, budgetary considerations are not a serious problem, nor, as some people argue, is this a question of raising the danger of misallocating capital on a world basis. To the contrary, since any additional Bank projects, particularly those for energy, are likely to earn above average economic rates of return, higher indeed than the worldwide average, this, if anything, would add to or contribute to a more optimum utilization of capital worldwide.

Now, I say I think a recommendation at the Versailles summit urging a move in this direction would be enough for all practical purposes, to put the program into effect, and it could not come at a more opportune time. Again, this makes me all the sadder that these kinds of issues do not seem to be on the table. That leaves open the very large question of what should be done for the poorest countries, for whom commercial bank lending is not a large possibility and who do not qualify for a very large amount of borrowing on hard terms from the World Bank and the regional bank. And here we simply have to recognize that the largest single source of capital to these countries at the present time is IDA, and unfortunately, the IDA program has had to be cut back because of the shortfall in the U.S. contribution.

Furthermore, and perhaps equally important, the discussion of the next replenishment of IDA, a replenishment that would enable the IDA program to continue from 1984 out, is now being postponed as a result of the unwillingness, perhaps inability of the United States to proceed.

Now, I think in principal, this could be changed if the United States was prepared to reverse its position and move ahead to meet its share of IDA obligations. That doesn't seem very likely to me now in the

context of the present budget, even though the amounts involved are comparatively modest. Alternatively, the other industrial countries, notably the six represented at Versailles, could say that they would be willing not only to meet their commitments in full, but possibly make up for some or all of the U.S. delinquency. There has been some movement in this direction, but it's doubtful to me that the total U.S. shortfall will be made up.

So I think that agian, in looking at this rather dour outlook, that this is the kind of subject that will be passed over lightly at Versailles, if not neglected all together; if so I think that the leaders of the industrial free world will be building up trouble for the future. You can't indefinitely slight the problems of this large portion of humanity, and I think that whatever happens at Versailles, in the end, this is an issue that the United States will have to examine itself in reconsidering its own priorities.

Bob Hormats said in the statement and in their subsequent discussion with him, Mr. Chairman, that it is for the United States to take the lead now, as it has in the past. This is an area in which not only have we been unable to take leadership, but an area in which our position has been holding back the rest of the world.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Fried follows:]

Prepared Statement of Edward R. Fried*

The Multilateral Development Banks and the World Economy

It now looks as though North-South issues will receive little attention at the Versailles economic summit. If so, this is a mistake. The heads of government of the seven most important industrial democracies cannot claim to be addressing the problems confronting the world economy without considering action in this field.

I propose to discuss one possible action of this kind--action to enable the World Bank and the Regional Banks to expand their lending to developing countries. This would be a feasible, cost-effective step to take at the present time. It would bring significant economic benefits to the oil-importing developing countries and in a modest way facilitate world economic recovery and contribute to an improvement in the world energy outlook--all at very small budgetary cost to the industrial countries.

To understand the need for such action it is useful to summarize the current world payments outlook in the wake of the oil price shock of 1979-80. The OPEC current surplus, after reaching a high of $115 billion in 1980, is rapidly disappearing because of weak oil demand and prices; it is likely to decline to $25 billion or even less in 1982.

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* The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its Officers, Trustees, or other staff members.

The current account of the industrial countries as a group will probably move into substantial surplus. On the other hand, the current deficit of the oil-importing developing countries will remain high--probably $85 billion this year, or in real terms about the same level it reached in 1980. The process of recycling OPEC money is now coming to an end; it is being replaced by the more usual surplus in the industrial countries and a counterpart deficit in the developing countries. In either case, the external debt of the oil-importing countries continues to mount; by the end of 1982 it will probably exceed $400 billion.

The reasons for the persistence of high current deficits for the oil importing countries are fairly straightforward. The jump in oil prices in 1979-80 initially added some $35 billion to their import bill, a burden that is only very slowly being worked down through increased exports of goods and services to the OPEC countries. In addition, the soggy OECD economies have taken their toll in the form of weak demand and prices for primary commodities and weak markets for manufactured exports. Finally, record high real interest rates have added to the foreign exchange burden of financing the external debt.

What is not generally appreciated, however, is the progress these countries have made in adjusting to the second oil shock. Economic growth, while one-third below trend levels, is still a respectable 4 percent or so. This has been accomplished by maintaining, if not slightly increasing, the share of investment in GNP, while reducing

the share of consumption. The comparative share of the net foreign resource inflow has declined because a considerable amount of belt-tightening has already taken place.

Performance has differed substantially among countries. For example, Brazil, Thailand and the Ivory Coast have done exceptionally well in their adjustment policies; Argentina, Zaire, and Sudan rather poorly. For the group as a whole, the pace of adjustment to the second oil price shock has been faster than it was after 1973.

One of the evident risks in this situation is that the foreign commercial banks, fearful about the persistence of large deficits and the mounting external debt, will sharply reduce their net lending. At present, net inflow of private commercial loans amounts to about $40 billion, or roughly 2 percent of GNP and 10 percent of net investment in the oil-importing countries. Should net commercial bank financing begin to dry up, at least some of these countries would suffer substantial economic setbacks, which could take a long time to reverse and which could have adverse consequences for world trade and the international financial system.

This is where the lending of the multilateral development banks plays an important role. Total loan commitments of the World Bank and the regional banks are now running at about $17 billion a year, and total disbursements at about $9 billion. By expanding lending now, these institutions would provide additional confidence to the commercial banks to continue their lending, either generally or through cofinancing Bank projects. The multilateral development banks,

contrary to some views, have had an excellent record in selecting projects with high rates of return. An increased volume of lending, therefore, would contribute to effective adjustment, looking toward a sustainable balance of payments and external debt equilibrium in the future.

Expanded lending for energy is a key element in such an approach. Increasing use of energy is an essential part of the development process. Twenty years ago the developing countries used about 10 percent of the free world's commercial energy; today, that proportion is 15 percent; by the end of this century, it is likely to be 25 percent. With high oil prices and, therefore, a high foreign exchange burden for oil imports, the energy constraint on the economic growth of the oil-importing developing countries will become worse unless remedial action is begun now. Such action consists of investments to expand domestic production of primary energy fuels and to improve the efficiency with which energy is used.

A successful energy program in the oil importing developing countries would also improve the economic outlook of the industrial countries. This clearly applies to the world oil market. The oil importing developing countries are likely to be the principal sources of increased demand on the world oil market for the indefinite future; by as early as 1990, their import requirements could amount to about one-fourth of net world oil exports. To the degree that their oil import requirements are contained, oil will be in more ample and more secure supply for all countries. The international trade and payments

system would also benefit. A stronger adjustment effort in energy would ease balance of payments difficulties, improve debt-servicing capacity, and lessen strains on international capital markets.

Such an approach would require a massive increase in energy investments in these countries. World Bank studies suggest that energy investments need to more than double over the course of the decade to a level of $40 billion to $50 billion a year (in 1980 dollars).

All available sources of capital would need to be tapped, private and public, domestic and foreign. However, there are serious political, technical, and financial obstacles to the mobilization and efficient use of capital in these countries. This is where the World Bank and the regional development banks should come in, helping to formulate least cost approaches, participating in financing, and through all this encouraging the inflow of foreign debt and equity capital.

The World Bank, which is the main source of quasi-public capital for these energy investments, now plans to devote about one-fourth of its lending to energy projects, including over $3 billion this year. This is the maximum it can lend now for energy without seriously compromising other high-priority programs, notably agriculture. If it had additional lending authority, the Bank believes it could easily double its energy program, all for projects with economic rates of return that are higher than the opportunity cost of capital in the countries concerned or in the free world as a whole.

Even if its program were doubled--and this deserves emphasis--Bank lending would represent less than 10 percent of estimated investment

requirements for energy. The measure of the program's success is the extent to which, through its projects, advice, and technical assistance, it can attract additional domestic capital for energy and additional foreign capital and know-how to supplement domestic resources. In general, capital from other sources associated with Bank projects is about two to three times the amount of Bank financing, and a strong effort is currently being made to increase this multiple.

To finance an expanding lending program, consideration was given to the establishment of a World Bank Energy Affiliate. Whatever its advantages, this proposal has had to be deferred because it does not have U.S. support.

Alternatively, the member governments could each year authorize an increase in the Bank's lending ceiling by an amount necessary to finance the additional identifiable energy projects that meet the Bank's lending standards but would otherwise be rejected for lack of financing. President Clausen has estimated that under present lending limits, such a shortfall could amount to $1 billion in 1982, $2 billion in 1983, and almost $4 billion in 1984. At the same time, the capital-surplus OPEC countries could be urged to cofinance additional Bank and energy projects through their existing assistance agencies or in other ways, in cooperation with an expanded Bank program. This would be particularly helpful in the poorest countries, where OPEC concessional financing would blend effectively with the Bank's financing on market terms.

Lifting the lending ceiling to finance these additional energy projects would require that the question of the next capital increase for the Bank would have to be acted upon one year earlier, that is, in 1984 rather than 1985. Meanwhile, no additional budgetary appropriations would be needed, and if it were agreed to increase capital subscriptions to the Bank in 1984, this probably could be done without a paid-in component, that is, without a further budgetary appropriation. Hence, budgetary considerations should not be a factor in deciding on an expansion of the energy program. Nor is there any evident danger of a misallocation of capital. To the contrary, since the additional projects are likely to generate above-average economic rates of return, expanding the Bank's energy program would, if anything, contribute to a more effective use of capital worldwide.

A recommendation at the Versailles economic summit urging the multilateral banks to move in this direction would for all practical purposes put the program into effect. It could not come at a more opportune time.

That leaves open the question of what can, or should, be done for the poorest countries. These countries are not sufficiently creditworthy to borrow from capital markets on a significant scale or to qualify for a large amount of hard loans from the multilateral development banks. They must rely heavily on bilateral aid or on the soft loan windows of the multilateral institutions for external capital.

The World Bank's soft loan affiliate, IDA (the International Development Association) is now the largest single source of such

assistance. Credits are extended on highly concessional terms but the projects must meet strict economic criteria. The program as a whole is designed to build infrastructure, that is, the foundations for economic growth and for subsequently mobilizing domestic and foreign private capital.

IDA's lending program, which was to be $4 billion a year for the period 1981-83, is now reduced by one-third because of the shortfall in the U.S. contribution, which in turn has triggered cuts from other countries. Furthermore, discussion of the next replenishment, which must begin soon if the program is not to be interrupted, is being delayed because of U.S. unwillingness or inability to proceed.

In principle this discouraging outlook might be changed in either of two ways. The United States might reverse itself and meet its share of the IDA obligations. This seems unlikely in the present budgetary atmosphere, even though the amounts involved are comparatively modest.

Alternatively, the other industrial countries, notably the six represented at Versailles, could announce their willingness to meet their commitments in full and possibly make up for some or all of the U.S. delinquency. While there has been some movement in this direction, the prospects for making up the U.S. shortfall look dim.

The likelihood therefore is that the Versailles meeting will pass over this subject lightly. If so, it is fair to say that the Summit leaders will be building up trouble for the future. We cannot indefinitely slight the problems of this large portion of humanity. Whatever happens at Versailles, in the end,this is an issue the United States will have to re-examine in the course of addressing its own priorities.

Representative REUSS. Thank you very much, Mr. Fried.
Mr. Sewell.

STATEMENT OF JOHN W. SEWELL, PRESIDENT, OVERSEAS DEVELOPMENT COUNCIL, WASHINGTON, D.C.

Mr. SEWELL. Thank you, Mr. Chairman.

Like Mr. Fried, I'd like to commend you on focusing attention on this set of issues which, as Mr. Fried said, are likely to be the neglected issues at the Versailles discussions next week.

I want to talk a little bit about these issues and particularly how they impact on the other industrial countries and on the United States, and I want to start out with the proposition that this morning's discussions in these issues are particularly important because in our own country a marked disparity now exists between our interests in the developing countries, between American interests in the Third World, and the low priority that most policymakers in this country give to our relations with these countries. And frankly, that disparity is due to the fact that we do not have a general understanding of the changes that have taken place in the position of developing countries in the world economy. I want to talk about that very briefly in summarizing my testimony, which you have a copy of. And that as long as that disparity continues, we're going to miss a series of opportunities, some of which Mr. Fried has alluded to in terms of the energy facility. The costs to this country are going to be higher, and we do risk permanently losing the leadership role that we have played over the last three decades on a bipartisan basis with cooperation both between the executive and the legislative branch in encouraging international development cooperation.

Now I think one of the problems that we face in discussing relations between the industrial countries and the Third World, and particularly between the United States and the Third World, is a lack of realization about the changes that have taken place in the position of the developing countries in the world economy. And we lose sight of the rather remarkable aggregate economic progress that has been achieved by those countries since the beginning of the 1950's. They grew, as I think you know, Mr. Chairman, at a rate over those three decades, much faster than we ever did in the industrial world at any time during the Industrial Revolution, and even during the very troubled 1970's, the annual GNP growth rate of the developing countries in the aggregate was close to 6 percent compared with just over 3 percent in the industrial countries.

Their manufactured exports have increased. They have come to a point where they are considerable participants in the international economy. You've seen this in two ways. You've seen them emerge as major participants in the world's trading system, not only as traditional importers of goods from the industrial world, which they are, and to which they have grown in a considerable extent, but also in a case, in many cases as major exporters of goods, both their traditional goods at the low end of the manufactured scale and, increasingly, a set of sophisticated and higher technology goods.

And you have in the second place seen the developing countries become major participants in the international financial system. There's an interesting transition that's gone on over the last two decades which

has escaped notice in a general sense in the composition of overall capital flows between the OECD countries and the developing world. In the beginning of the 1960's, close to two-thirds of the total financial resources transferred from the industrial world to the Third World are in the form of concessional assistance, foreign aid. But by the end of the last decade, that percentage had diminished to less than a third, and private sector flows of a variety of kinds, mainly in explosive growth and private bank lending, had increased to well over two-thirds of the total. This is a major transformation, when one looks over the 1980's, because it means that the developing countries in the aggregate are now important participants in both the stability of the international financial system and certainly in any future growth of the world's trading economy.

In my prepared statement I go in, in some detail, to the implications of this to the United States, because in this area, as in others, we suffer a very—sort of cultural lag, having been relatively autonomous from the world's economy throughout our history and about how much that position has changed in the recent past.

Attached to my prepared statement are a series of tables drawn from some of the publications of the Overseas Development Council which reflects this. If one looks at the area of trade, the developing countries as a whole now represent one of the largest markets for U.S. goods, at a time when the exports, as a percentage of U.S. GNP have grown from 6 percent in 1960 to almost 13 percent in 1980. The nonoil developing countries now purchase a greater share of our exports, greater than that sold to the European Community, Eastern European, the Soviet Union and China combined, and this is illustrated in table 1 attached to my prepared statement. They have become major export markets both for our manufactured goods and our agricultural products. And yet we don't really give this sufficient policy attention.

The second table attached to my prepared statement looks at the major 20 export markets for the United States. Of those 20 countries, 11 of them are in the so-called "Third World," and where a great deal of time and effort is spent both in the public and private sector worrying about our trade balance with Japan, very little time is spent, say, worrying about our trade balance with Nigeria, where the deficit is roughly the same, brought about by the fact that we buy all that oil from Nigeria and manage to sell them very little. And this pattern is repeated for other developing countries also.

We see the growing importance of the developing countries in the commodity trade field. They provide us with a variety of strategic mineral resources, despite the fact that the United States remains one of the biggest exporters of raw materials, and of course, in terms of our markets, they are the major market for the bountiful surplus of the American agricultural system. Nearly 40 percent of our grain exports go to the developing countries and U.S. agricultural production, for instance, brought in more than $41 billion in export earnings in 1980.

By the same token, the United States is directly affected by the shift in resource transfers that I referred to earlier.

Table 4 attached to my prepared statement lays out American private bank lending to developing countries. U.S. banks now account for some 60 percent of total commercial bank claims on nonoil exporting middle-income developing countries. U.S. bank claims on develop-

ing countries totaled about $128 billion in mid-1980, and they've been growing at a very rapid rate, as private bank lending has expanded in the course of the last decade. And much of the same growth is seen in the field of private foreign direct investment which grew at an average annual rate in the developing countries of about 29 percent in the last decade and grew at a much slower rate in terms of the investment in the industrial world.

All of this, of course, is natural, even in terms of traditional economic theory, because the difference between the developed and the developing countries, in terms of position in the world leads to an almost classic working of the theory of comparative advantage.

The conclusion from this brief summary of the importance of the Third World to the United States is obvious. The developing countries are not important participants in the international economy, but they're now important trading partners and financial partners of the United States. Therefore, ignoring their economic problems as, unfortunately, the Versailles summit seems likely to do, is going to have a direct impact on the ability of these industrial countries and of the United States to address our own economic problems. And for that reason, I think these issues should move much higher on the agenda of the industrial countries summit.

That conclusion is reinforced by the fact that the economic outlook for the 1980's, as previous witnesses have gone into, is, I should say, not particularly bright. I think it's now generally accepted that the choice by the developing countries to maintain their economic growth in the 1970's after the first oil shock, had an important and measurable impact on growth in the North. The fact that they were willing to continue to expand their exports, that they borrowed heavily from private banks and other sources, meant a source of demand for goods from the North which, at least in the mid-1970's was extremely favorable and made our economic situation somewhat less worse.

EFFECT OF STAGNATION IN DEVELOPING COUNTRIES ON INDUSTRIAL ECONOMICS

The key issue for the 1980's, therefore, is how long can any amount of growth in the developing countries be maintained in an increasingly adverse set of economic circumstances, or conversely, if you want to put it the other way around, what's going to be the impact of stagnation in the developing countries on the economies of the industrial world?

As a number of other witnesses have talked about the rather dismal economic prospects for the years ahead, let me just run over those points we highlight in my testimony, briefly.

World trade is barely growing at all, in fact, in 1981, actually declined in terms of value, the threat of protectionism is on the increase, and I think for those people who believe in the magic of the marketplace, the renewal of the Multifibre Agreement in the recent past on more restrictive terms was a major missed opportunity to actually let the market work, begin to work for some parts of the Third World. The debt of the developing countries continues to mount rapidly. It now totals $526 billion and debt servicing payments, as a result, continue to grow. For the major debtor countries, the 10 or 20 countries that hold most of the private debt in the developing world, the pros-

pects are not good for their ability to handle this debt without some restoration of global economic growth.

And we are at a point with high interest rates, where a number of observers have calculated that changes in the interest rate in the United States have a greater impact on the major nonoil developing countries that are heavily in debt than changes in the price of oil. It was a Morgan Guaranty Bank estimate that indicated that a 1-percent change in the U.S. interest rates has a greater impact on the nonoil developing countries than does a 1-percent increase in the price of oil.

Mr. Fried has already mentioned the change in the OPEC surplus with a movement to surplus in the industrial countries and the implications of that, and it is clear that financial conditions in the Third World are becoming highly politicized as more and more countries run into financial difficulty. It's still somewhat ironic that after all the worries of the 1970's about the world debt situation, particularly in the developing countries, that the major current problem involves Poland and not any country in the Third World. But it's worth noting that the number of countries experiencing arrears on current payments has increased from 3 in 1974 to 26 at the end of 1980. And the amount in arrears has risen from some $500 million to $5.5 billion over that period of time.

Between 1956 and 1974 there were 30 debt renegotiations involving 11 countries and a total debt of $7 billion, but in the 7 years since that time, however, there have been 24 debt renegotiations involving 14 countries and a total debt of over $10 billion.

FINANCIAL FLOWS TO DEVELOPING COUNTRIES

Finally, it seems to me that as we all agree that regrettably the flows of official development assistance are going to, at best, grow very slowly, at least I must say partially due to an abdication of the United States in leadership in this area, one has to raise the question of the ability of the private financial markets to deal with the needs of developing countries in the period ahead. My own view is that private investment credit flows are not likely to take up the slack as they did to a major degree in the mid-1970's.

If one looks, for instance, at U.S. direct foreign investment, over the last several years it's declined dramatically from $24 billion in 1979 to $7 billion last year. And you're running into a situation where the prospects for this interrelated system of trade and finance in the years ahead are not particularly bright. Pressures on this system are building, and the aggregate problem seems to me at the very least to be serious enough to demand priority attention of the leaders of the world's industrial powers when they meet next week in Versailles.

SET GROUNDWORK FOR MUTUALLY BENEFICIAL INTERDEPENDENCE

Let me now end by saying—suggesting very briefly, as we do in the testimony, that there are things that could be done. I would argue for several. One is a very strong pledge by the industrial country leaders for a standstill on trade restrictions, including on tariff barriers, that a strong trade pledge, it seems to me, could send a very strong signal not only to the world but could set the grounds for the meeting of the ministers of the GATT in the fall in a very beneficial way.

Second, there needs to be some sort of serious discussion of mechanisms to provide a cooperative financial safety net to help, at an early stage, countries that run into difficulty in dealing with their debt and financial problems. Currently, those problems are managing on an ad hoc manner, and usually, when they reach near-crisis proportion.

Third, and it seems to me I'd like to back up Mr. Fried's excellent statement fully, that we need an indication, particularly from the United States, that it's willing to meet its full current commitments to the international financial institutions, particularly to IDA, and when the discussions of the Seventh Replenishment come up to be forthcoming in that particular area.

Finally, I would argue that the summit participants, the seven leaders, should reach some agreement and indicate their willingness to hold another North-South summit similar to that held in Mexico last fall. We're at a stage in the world where the integration of the world's economy has far outrun the capacity of our institutions to deal with it, particularly, across the North-South dividing line. We know one of the benefits of the industrial countries' summit has been a periodic opportunity for political leaders at the highest level to discuss their own problems and the constraints they have on their own actions. And that, I think, was one of the benefits of the meeting at Cancun, despite its other limitations, and I would hope we could begin to institutionalize that process, not necessarily on an annual basis, so that leaders could reach across this North-South dividing line.

Let me turn to my original point, in closing. Unfortunately, relations between the First and Third World are not going to loom large on the agenda at Versailles, and that, it seems to me, is a loss.

I close my testimony with a quote which I would like to read to you, because I think it is an indication of the right sentiment:

> We have a great opportunity for change in our relations with the developing countries. It is one of the ironies of our age that as nations have become more powerful, their destinies have grown more interdependent. Together, we and the leaders of the developing countries have an opportunity to make sure that this interdependence is a source of mutual benefit founded on a solid ground of common interest. The consequences of failure to cooperate would be disastrous for both America and the Third World.

I'm in full agreement with that quote. It comes from a speech which the current Secretary of State gave at a chamber of commerce meeting last month. I think it's too bad it won't provide the motivation, both for American policy and for discussions at the summit next week.

Thank you.

[The prepared statement of Mr. Sewell, together with attached tables, follows:]

Prepared Statement of John W. Sewell

MR. CHAIRMAN, I am pleased to have been invited to testify on the prospects for the next economic summit at Versailles. I would like to talk about a series of issues which I understand are not likely to receive major attention at the Versailles discussions. These are the international economic issues that impact on both the industrial and the developing countries--the so-called North-South issues.

Much of my testimony is drawn from two recent publications of the Overseas Development Council. The first is U.S. Foreign Policy and the Developing Countries: Agenda 1982, the eighth in ODC's annual assessment of American relations with the developing countries. The second is a just released paper entitled The Ties that Bind: U.S. Interests and Third World Development. I would be happy to make copies available to members of the Committee. I also am indebted to my ODC colleague, John Mathieson, as I have drawn from his work. The testimony, of course, reflects my own views and not those of the Council, its staff or Board.

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These issues are important because a marked disparity now exists between U.S. interests in the developing countries and the low priority that policymakers in this country assign to our relations with these countries. This disparity results from a lack of understanding of the changes that have taken place in the position of the developing countries in the global economy over the past two decades. U.S. foreign policy still does not reflect adequately the emergence of the developing countries as important participants in the international arena. As long as this disparity continues, opportunities will be missed, the costs to the United States will be higher, and the risk of permanently losing the leadership role the United States has played for so long in encouraging international stability and cooperation will be greater.

It is for this reason that I regret that several important issues affecting both the industrial world and the developing countries apparently will not receive high priority at the Versailles summit discussions, and will not be emphasized by the government of the United States. North-South issues have, of course, always been on the agenda of the preceeding economic summit meetings. However, they have usually been given a low priority and have been relegated to the very last part of the discussion. This was true even at last year's meeting, which was designed in part to prepare for the North-South summit meeting at Cancun, Mexico. This year, North-South issues are likely to be swamped by concerns among the summit participants over domestic U.S. economic policy and by attitudes toward economic and political cooperation with the Sovie Union. This is a shortsighted view. The economic problems of the rich

countries no longer can be solved in isolation from and in ignorance of the financial and development concerns of the poor countries.

My statement will cover first some background about the emergence of the developing countries as major participants in the international economic system; second a brief, sobering, but hopefully not alarmist, sketch of current global economic conditions; and third, a few suggestions of steps that could be taken at Versailles.

The Emergence of the Developing Countries

First, let me turn to the growing importance of the developing countries in the world economy. In our current uncertain economic situation, we lose sight of the rather remarkable aggregate economic progress that has been achieved by the developing countries over the past three decades. They have, in fact, grown over that period at a more rapid rate than did the industrial world at any time during the industrial revolution. Even their progress during the troubled 1970s was in some respects astonishing. The annual GNP growth rate of the developing countries in the 1970s was 5.7 percent (compared with 3.4 percent in the industrial countries). And despite the increase in protectionist measures, in the mid-1970s their manufactured exports increased at an annual rate of more than 10 percent. This progress, of course, was very unevenly spread and masked the continued existence of mass poverty, as well as vast differences in performance among and within countries. While some countries--the so-called Advanced Developing Countries--are now minor industrial powers, others--particularly in sub-Saharan Africa--remain very poor,

with only meager long-term prospects for economic and social development in the future. Nevertheless, it is accurate to say that the developing countries in the aggregate, and in some cases individually, are now major participants in the world economy.

This increased participation is reflected in their growing importance in both the world's trading and financial system. During the last two decades international trade expanded rapidly--its value increasing about 11 percent each year in the course of the 1960s, and 20 percent each year in the 1970s. The developing countries benefitted greatly from that growth, and a number of them became important exporters, not only of traditional primary products but eventually of sophisticated manufactured goods as well. During the decade of the 1970s, growth in trade provided an increase of about $145 billion (1980 dollars) in the purchasing power of oil-importing developing countries. This is four times as much as the $36 billion increase in purchasing power attributable to external finance.

Second, the developing countries became major participants in the international financial system. This fact is reflected in the composition of overall capital flows between industrial and developing countries which have undergone a major shift. In the mid-1960s about 60 percent of total financial resources transferred from developed to developing countries were in the form of concessional assistance, with private sector flows accounting for the remaining 40 percent. By the end of the 1970s, the percentages had more than reversed, with concessional assistance falling to only 30 percent of the total, and private sector flows increasing to almost 70 percent. The growth in private flows

(along with higher prices for oil and other products) has also led to a multiplying debt burden. LDC debt grew at a rate of 23 percent a year during the 1970s and at the end of 1981 totalled $526 billion.

This shift in the pattern of financial transactions and the growing participation in the world trading system has considerable implications for the future. It means that the developing countries in the aggregate are now important participants, both in the stability of the international financial system and in the future growth of the world trading economy. In both areas, their growing importance of the economic health of the rich countries is underappreciated in policy circles.

It is important to be aware that these developments have had a considerable impact on the United States as well. We still tend to think of the United States as relatively less affected by the international economy than other countries. To a certain extent, that is true. But our economic involvement with the developing world has been growing rapidly over the last decade or two. Let me give you some examples.

1. In terms of trade, the developing countries as a whole now represent the largest market for U.S. goods at a time when exports as a percentage of U.S. GNP have grown from 6 percent in 1960 to almost 13 percent in 1980. They purchased about 38 percent of total U.S. exports in 1980--a share greater than that sold to the European Community, Eastern Europe, the Soviet Union and China combined (Table 1). Developing countries purchase an average of 23 percent of industrial-country

exports, which is a significantly smaller share than the 38 percent they buy from the United States. The developing countries have emerged as major export markets for American manufactured goods and agricultural products, in many cases far outstripping in growth terms our more traditional markets in the industrialized world (Table 2). Trade, of course, has a series of impacts on the American economy. For example, it helps maintain lower consumer prices, as consumer-good imports from the developing countries are on the average 16 percent lower than comparable goods imported from our industrial partners. But it also directly affects American firms, communities and workers in industries adversely affected by competition with imports from developing countries.

2. The same growing importance is evidenced in the commodity trade field. We depend heavily on the developing countries for many strategic materials, despite the fact that we have considerable mineral resources of our won (Table 3). In 1978, for instance, U.S.net imports from developing-country market economies accounted for 93 percent of domestic consumption of tin; 88 percent of columbium; 56 percent of aluminum; and 35 percent of manganese. I don't have to mention our dependence on imported oil and the fact that literally all of such items as rubber, coffee, cocoa, hard

fibers, and jute come from the developing countries. But we also are major exporters of a very important commodity, that is food; the United States is the largest exporter of cereal grains. Nearly 40 percent of our grain exports go to the developing countries, constituting nearly two thirds of their imports. U.S. agricultural production brought in more than $41 billion in export earnings in 1980, and roughly one out of three U.S. farm acres produces for exports, and one out of five for export to the developing countries. The United States thus is both a recipient and supplier of crucial commodities.

3. The United States also is directly affected by the growing role of the developing countries in the international financial system. U.S. private bank lending to these countries has been expanding rapidly. U.S. banks account for some 60 percent of total commercial bank claims on non-oil-exporting middle-income countries. Total U.S. bank claims on developing countries amounted to $128.6 billion in mid-1980 (Table 4) and have been growing at an average rate of about 30 percent a year following the oil crisis of the early 1970s. Interest from these loans constitutes a large and growing share of overall U.S. bank revenue. Much the same growth has been seen in the field of direct foreign investment (Table 5).

> U.S. foreign direct investment in the developing countries (excepting the petroleum sector) grew at an average annual rate of 29 percent between 1970 and 1979 in the developing countries, while the comparable figure for investment in other industrial countries was 16 percent. By 1980 almost 32 percent of total U.S. direct investment income came from the developing countries. And the developing countries provided by far the bulk of net U.S. service transaction earnings, providing a healthy benefit to the American balance of payments.

The conclusion from this brief summary is obvious: the developing countries are not only important participants in the international economy, they are also important trading and financial partners of the United States. Ignoring their economic problems and their economic prospects, therefore, will have a direct impact on the ability of the industrial countries, including the United States, to address their own economic problems. These relations with the developing countries pose issues that should be high on the agenda of the industrial-country summit.

The Current Situation

It is now generally accepted that the continued growth by the developing countries after the first oil shock in 1973 had an important and measurable impact on growth in the North. This impact, of course, was a direct result of the growing economic importance of the Third World which emerged in the 1970s. As

I indicated earlier, this progress continued up until the end of the last decade. The key issue for the 1980s, therefore, is how long can growth in the developing countries be maintained in an increasingly adverse set of economic circumstances. Or perhaps conversely, the question should be, what will be the impact of stagnation in the developing countries on the economies of the North?

The importance of these questions is underlined when one looks at the current sobering economic situation facing both rich and poor countries.

1. The combination of uncertainty and depressed economic demand has dampened the growth of world trade. The rate of growth in the volume of world trade has fallen from an average annual rate of 8 percent in the 1960s to 6 percent in the 1970s, to only 1.5 percent in 1980, and to no growth at all in 1981. In 1981, for the first time since 1958, the value of world trade actually declined by 1 percent. Markets in the industrial countries are growing very slowly as the OECD economies are wracked by low growth, high interest rates, and continuing unemployment. The developing countries, faced with large current account deficits and highly uncertain futures, are cutting back expenditures, which in turn have a direct impact on the imports they normally buy from the OECD countries.

2. The threat of protectionism is on the increase. Although there is no precise delineation of the extent of protectionist

measures, the trend is ominous. The just negotiated renewal of the Multifibre Agreement was more restrictive for imports of textiles and apparel from the developing countries; the U.S. decision to institute import quotas for sugar is another indication; and a growing demand for "reciprocity" by the industrial countries indicates that protectionist pressures are rising rapidly.

3. The debt of the developing countries continues to mount rapidly. It now totals $526 billion and debt servicing payments have risen to at least $60 billion a year in 1981. Debt service ratios for many middle-income countries are approaching very high levels; debt service now represents 4.4 percent of GNP and 13.9 percent of exports of these countries. In addition, the terms of debt appear to be deteriorating as interest rate spreads increase and maturities shorten. Much of this debt, of course, is owed by relatively few middle-income countries. But the prospects for these major debtors is not good unless there is a restoration of global economic growth. For instance, for Brazil debt servicing as a percentage of exports has grown from 13.3 percent in 1973 to 34.6 percent by 1979, as Brazil's debt has grown at an average annual rate of 26 percent a year over the same period.

4. Real interest rates, that is, those adjusted to account for inflation, are at historic highs. Where real interest rates once were at a level of 2-3 percent, they now range as high as 11-12 percent. The impact on the economies of industrial and particularly developing countries is considerable. Morgan Guaranty Bank has indicated that a 1 percent change in the U.S. interest rate has a greater impact on the non-oil developing countries than does a 1 percent increase in the price of oil. Other commentators have indicated that a 1 percent increase in international interest rates, which are closely tied to U.S. rates, adds anywhere between $1 to $4 billion to the deficits of developing countries.

5. Due to depressed prices and demand for oil, the OPEC surplus will be much smaller than expected. The oil exporters had been major sources of funds for private capital markets. After the last oil price increases in 1979 and 1980, some predicted that the surplus of the OPEC countries would run at a level of $100 billion a year, well into the 1980s. As with many predictions concerning energy, this estimate was incorrect. The actual OPEC surplus in 1981 was only $60 billion; current estimates suggest that in 1982 the OPEC countries collectively will have a deficit--perhaps as high as $10 billion or more. The decrease in the oil

price, of course, benefitted some developing countries. However, because of their heavy involvement in the world economy and their growing debt burden, the decrease in oil prices did not offset the impact of stagnation for their export markets or the continuing burden of high interest rates. Therefore, they benefitted least of all from the soft oil markets.

6. Financial conditions in the Third World are becoming highly politicized as more countries appear to run into financial difficulty. It is ironic that the current major debt problem involves Poland, and not any particular Third World country. But the severe problems and sensitive political positions of such countries as Zaire, Turkey, Iran, and now Argentina underline the fragility of the system and the spillover effects of financial issues into general foreign policy concerns. It is also worth noting that the number of countries experiencing arrears on current payments has inceased from 3 in 1974 to 26 at the end of 1980; and the amount in arrears has risen dramatically from $500 million to $5.5 billion. Between 1956 and 1974 there were 30 renegotiations for 11 countries involving a total debt of $7 billion. In the seven years since 1975, however, there have been 24 debt renegotiations for 14 countries involving a total debt of about $10 billion.

7. Flows of Official Development Assistance will probably increase somewhat in the 1980s but at a much slower rate than in the 1970s when ODA grew at 4 percent a year in real terms.

8. Finally, the ability of private financial markets to deal with the needs of the developing countries is coming into question. Private investment and credit flows are not likely to take up the slack, as they did in the mid-1970s. To take but one example, U.S. direct foreign investment has declined dramatically in recent past. In 1979, the United States invested $24 billion overseas; in 1980 $18.5 billion. But in 1981 the total dropped to $7 billion. Many business firms will not invest in long-term, relatively risky projects when they can receive high returns from short-term liquid investments. At the same time, capital flows into the industrial world, and particularly the United States, are growing in significance. Capital inflows to the United States rose to $50 billion in 1980 and $74 billion in 1981, with over one half of the latter coming in the form of short-term bank deposits, including major inflows from Latin America. U.S. official reserves, not counting gold, increased from $7.8 billion at the end of 1979 to $18.9 billion at the end of 1981.

The prospects for this interrelated system of trade and finance in the years ahead are not particularly bright. Pressures on the international economic and financial systems are building. Many of these pressures, of course, are the consequences of current economic stagnation, and if non-inflationary growth will be restored, particularly in the industrial economies, would diminish. But such a recovery is unlikely in the short run. And prudent planning would suggest that in a world heavily laden with debt, with slow growth and high inflation, the world's economic system will become increasingly fragile. The aggregate problem seems to me, at the very least, to be serious enough to demand the attention of the leaders of the world's seven major industrial powers when they meet next week at Versailles.

What Can Be Done At Versailles?

Finally, I would like to briefly mention a few possible actions that could be taken at next week's meeting. My agenda would include:

1. A commitment to negotiate a standstill on trade restrictions, including non-tariff barriers, which would restore a crucially needed degree of certainty. A strong "trade pledge" would be a very useful political endorsement to blunt the growing pressures for protectionism and set the groundwork for the discussions at the Ministerial Meeting of the GATT this fall. American leadership in this area would be crucial.

2. Serious discussion of a cooperative financial "safety net" to deal with and assist at an early stage countries running into financial difficulties is clearly warranted. Currently, debt servicing problems are managed in an ad hoc manner, and usually only when problems reach near-crisis proportions.

3. We also need an indication, particularly on the part of the United States, of donor-country willingness to meet full current commitments to the international financial institutions, particularly the International Development Association, as well as a pledge from world leaders to give full consideration to the Seventh Replenishment of the IDA at a level commensurate with the particular needs of the low-income countries.

4. The summit participants should reach some agreement to eventually hold another "North-South summit," such as that held at Cancun, Mexico last year. The meeting, while not yet leading to concrete results, at least provided a frank and open forum where leaders from both North and South could discuss their problems and constraints. In the period ahead when the integration of the world's economy has far outrun the ability of existing institutions to cope with this grow-

ing interdependence, informal summit meetings such as that at Versailles are of considerable importance because they provide a forum for interchange among leaders. As the developing countries are now participants of growing importance to the international economy, a continuation of the North-South summit on some periodic basis (not necessarily each year) would be an indication of the importance that the leaders of the industrial countries assign to mutual problems with developing countries.

* * * * *

Let me finally return to my original point. Relations between the industrial and developing countries should loom large on the agenda of the Versailles summit discussions. The fact that they are not likely to be accorded that priority runs counter to the realities of growing world economic interdependence and the important role now played by the developing countries. This was perhaps put no more succinctly than in the following statement:

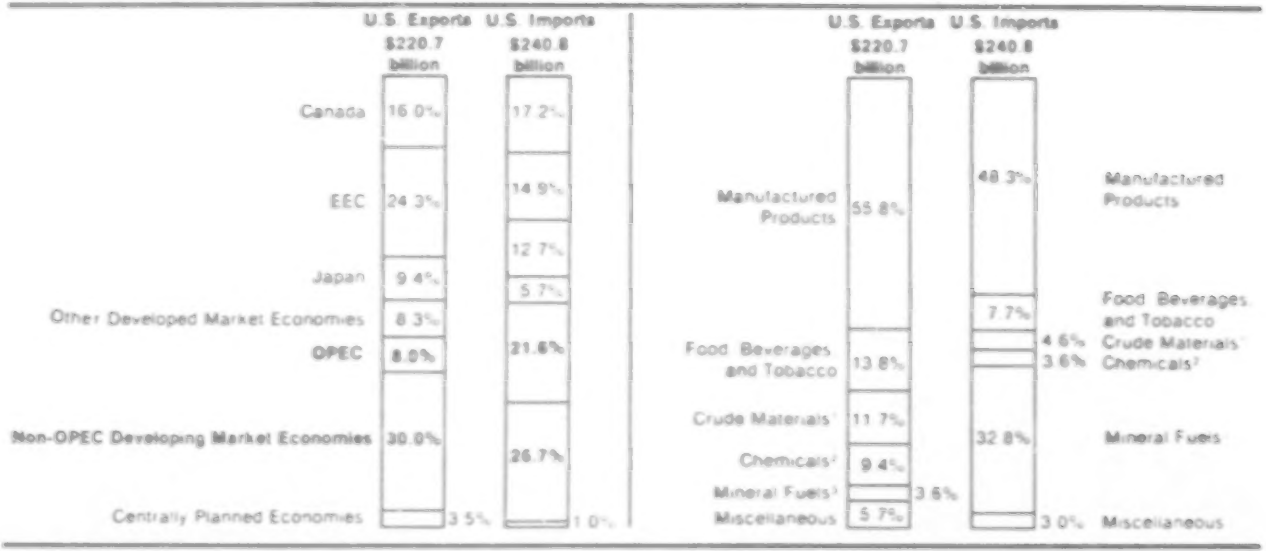
> "... We have a great opportunity for change [in] our relations with the developing nations. It is one of the ironies of our age that as nations have become more powerful their destinies have grown more interdependent. Together, we and the leaders of the developing countries have an opportunity to make sure

"that this interdependence is a source of mutual benefit, founded on the solid ground of common interest. The consequences of failure to cooperate would be disastrous for both America and the Third World . . . ."

That quote was from a speech given by Secretary of State Haig at a meeting last month in Washington. I would hope that it would provide the motivation for both American policy and for the discussions of the leaders at the economic summit.

Attachments:

D-8. U.S. Trade, 1980
(5 billions and percentages)



[1]Includes cotton, animal raw hides and skins, crude rubber, logs and lumber, and oil and fats.
[2]Includes fertilizers.
[3]Includes lubricants and related materials.

NOTE: Export and import figures are f.a.s. (free alongside ship) transaction values. Totals include trade with unidentified countries not otherwise shown on this table.

SOURCE: U.S. DOC, *Highlights of U.S. Trade (1980)*, Tables E-2, E-3, I-2, and I-6.

Table 2

A-2. Twenty Largest U.S. Trading Partners, 1980
($ billions and percentages)

The twenty largest U.S. trading partners, in terms of total merchandise transactions, include eleven developing countries, which together account for more than 25 per cent of all such transactions and 33 per cent of all U.S. imports. Mexico is the third largest trading partner of the United States.

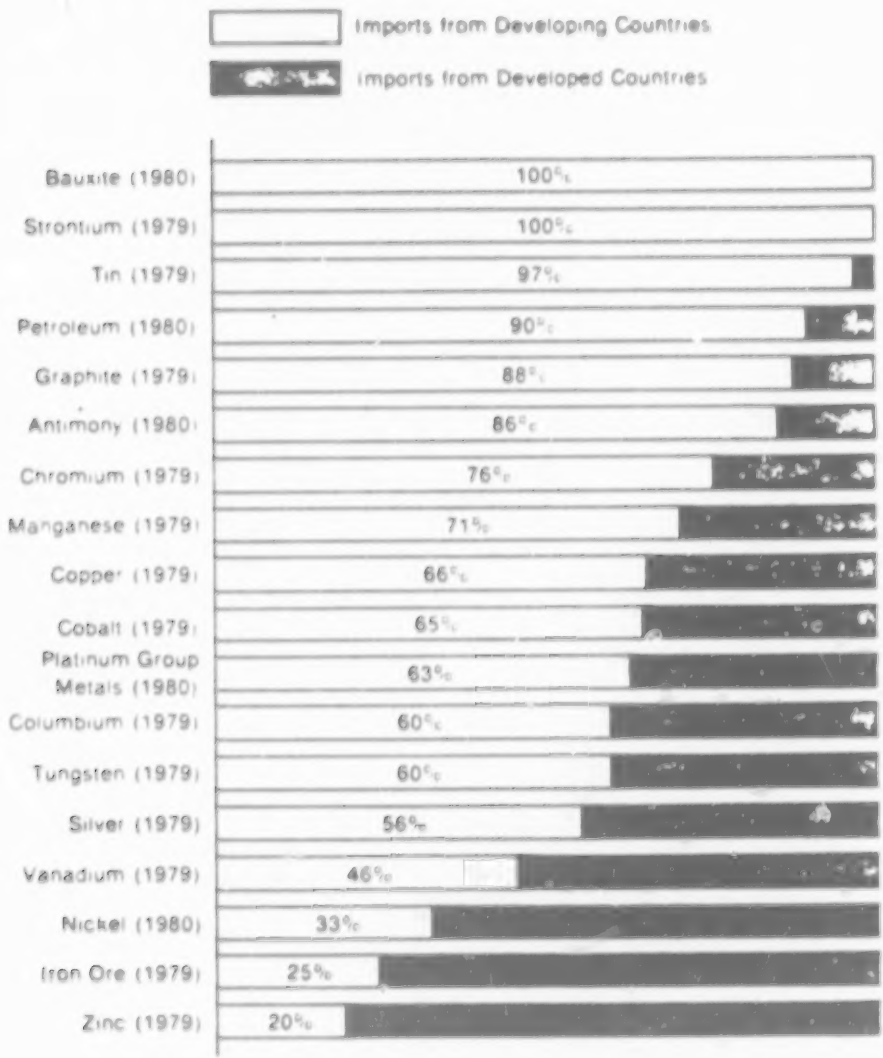
	Total Transactions	Exports	Imports
Canada	$ 76.9	$ 35.4	$ 41.5
Japan	51.5	20.8	30.7
Mexico	*27.6*	*15.1*	*12.5*
West Germany	22.7	11.0	11.7
United Kingdom	22.5	12.7	9.8
Saudi Arabia	*18.3*	*5.8*	*12.5*
France	12.7	7.5	5.2
Nigeria	*12.1*	*1.2*	*10.9*
Taiwan	*11.1*	*4.3*	*6.8*
Netherlands	10.6	8.7	1.9
Venezuela	*9.9*	*4.6*	*5.3*
Italy	9.8	5.5	4.3
Korea, Rep.	*8.8*	*4.7*	*4.1*
Belgium-Luxembourg	8.6	6.7	1.9
Brazil	*8.0*	*4.3*	*3.7*
Libya	*7.6*	*0.5*	*7.1*
Hong Kong	*7.4*	*2.7*	*4.7*
Algeria	*7.1*	*0.5*	*6.6*
Indonesia	*6.7*	*1.5*	*5.2*
Australia	6.6	4.1	2.5
Total, 20 Countries	$346.5	$157.6	$188.9
Total U.S. Trade	$461.5	$220.7	$240.8
11 Developing Countries as % of Total U.S. Trade	**27.0%**	**20.5%**	**33.0%**

NOTE: All figures are f.a.s. (free alongside ship) transaction values.

SOURCE: ODC table based on U.S. DOC, *Highlights of U.S. Trade* (1980), tables E-3 and I-6.

Table 3

A-5. U.S. Imports of Selected Metals and Minerals (percentages of total imports)



SOURCES: ODC table based on data from U.S. Dept. of the Interior, Bureau of Mines, and U.S. Dept. of Energy.

Table 4

A-7. U.S. Bank Lending Abroad, 1979 and 1980 ($ millions)

	Total Claims June 1979	Total Claims June 1980
Developed Market Economies	**106,174.7**	**131,581.9**
of which		
United Kingdom	36,515.9	42,918.3
Japan	13,500.2	17,999.4
France	9,691.2	11,467.9
Belgium-Luxembourg	6,913.3	10,983.0
Canada	5,612.8	7,844.3
Centrally Planned Economies	**5,438.5**	**5,814.9**
of which		
Poland	1,514.9	1,743.6
German Democratic Republic	1,100.9	1,332.1
U.S.S.R.	815.4	548.7
China, People's Rep.	66.4	113.2
Developing Market Economies	**109,297.7**	**128,565.0**
OPEC	19,792.6	19,857.3
of which		
Venezuela	7,712.1	8,313.7
Indonesia	2,262.7	1,984.0
Iran	2,130.6	772.9
Algeria	1,830.4	1,669.4
Ecuador	1,540.6	1,752.1
Non-OPEC	89,505.1	108,707.7
of which		
Brazil	13,606.9	13,991.8
Mexico	10,448.9	12,760.3
Korea, Rep.	4,824.0	6,889.3
Taiwan	3,455.2	3,977.6
Argentina	3,421.4	5,643.7
Other (International and Regional Organizations)	**420.4**	**224.1**
Total	**221,331.7**	**266,186.3**

NOTES: In 1979 nearly three quarters of the claims had a maturity of one year or less; in 1980 short-term claims amounted to two thirds of the total.

SOURCES: ODC table adapted from U.S. Comptroller of the Currency, Federal Deposit Ins. Corp. and Federal Reserve Board, "Country Exposure Lending Survey," December 14, 1979 and November 24, 1980.

A-6. U.S. Direct Investment Position in Developing Countries, 1967 and 1980 ($ millions and percentages)

	1967 ($ millions)	1967 (% of region)	1967 (% of total)	1980 ($ millions)	1980 (% of region)	1980 (% of total)
Latin America	**10,102**	**100.0**	**68.1**	**27,401**	**100.0**	**52.4**
Venezuela	2,081	20.6		7,546	27.5	
Mexico	1,426	14.1		5,940	21.7	
Brazil	961	9.5		3,190	11.7	
Other Latin America	5,634	55.8		10,725	39.1	
Africa	**1,492**	**100.0**	**10.0**	**3,730**	**100.0**	**7.1**
Libya	350	23.5		1,029	27.6	
Nigeria	271	18.2		577	15.5	
Zambia	138	9.3		2,124	56.9	
Other Africa	733	49.0				
Middle East[1]	**1,540**	**100.0**	**10.4**	**1,942**	**100.0**	**3.7**
Iran	317	20.6		1,891	97.4	
Other Middle East	1,223	79.4		51	2.6	
Asia and Oceania	**1,517**	**100.0**	**10.2**	**8,397**	**100.0**	**16.0**
Philippines	550	36.3		1,969	23.4	
India	249	16.4		1,334	15.9	
Hong Kong	173	11.4		1,244	14.8	
Other Asia and Oceania	545	35.9		3,850	45.9	
Other[2]	**188**	**100.0**	**1.3**	**10,874**	**100.0**	**20.8**
Total	**14,839**		**100.0**	**52,344**		**100.0**

[1]Bahrain, Iran, Iraq, Jordan, Kuwait, Lebanon, Neutral Zone, Oman, Qatar, Saudi Arabia, Syria, Yemen Arab Rep., and Yemen Dem. Rep.
[2]Bermuda. Roughly 95 per cent of U.S. investment in Bermuda by year-end 1980 was in finance and insurance.

NOTE: Figures represent cumulative U.S. investment as of year-end 1967 and year-end 1980.

SOURCES: ODC table based on data from U.S. Department of Commerce, Bureau of Economic Analysis, and U.S. DOC, *Survey of Current Business*, Vol. 61, No. 8, August 1981, p. 32.

Representative REUSS. Thank you very much, Mr. Sewell.

FUTURE CREDIT SHORTAGE FOR DEVELOPING COUNTRIES

I have a question for the entire panel. It seems to me that a number of factors suggest that there could well be a real shortage of available credit for the less-developed countries in the years ahead. The Polish debt situation and other near defaults or defaults have spooked international banks considerably on further commercial bank lending.

OPEC's surplus, as you all have pointed out, is shrinking. And that would seem to reduce the pool available for international lending of savings. Plans in this country and in Europe for revitalizing industries are going to put a huge and legitimate demand on credit for domestic purposes.

Do any of you have observations to make about whether there will, in fact, be a credit shortage for the less-developed countries, and particularly on whether such a shortage is incapable of alleviation, or whether things could be done about it?

Does anybody want to address it?

Mr. Klein.

Mr. KLEIN. Well, I don't think there's any doubt that the conditions, terms under which credit is going to be made available is going to be more restrictive, at least in the near term. But I think it's worthwhile looking at a few of the points you just made.

If the OPEC surplus disappears, as I think it will, that is not necessarily a bad thing for the developing countries. It means that the funds get shifted to some extent into other hands.

In the past, there are two things I think happened with the OPEC surplus. Some of it was made available directly to developing countries who are friendly with the OPEC nations. And that was quite OK—very selective.

In addition, the OPEC funds have been invested around the world, a great part in the private banking system. And then it became the risk responsibility of the private banking system to relend all over the world and, in particular, in great measure to the developing countries.

So, it took the risk from OPEC and put the risk on private banks. And then the private banks are having, as you recognize, these unfortunate series of circumstances that change their attitudes toward making those loans.

I think it gives us a new set of problems. It also might give us a new set of opportunities.

It does mean the great industrial nations who will now be in surplus have to be encouraged to take a more sympathetic attitude toward capital transfers, capital availability for the developing countries. And it also means that the United States has to consider its attitude toward, let's say, the extremes of making funds available or relying on the magic of the market.

I think if we just look at the situation as forecasters, as I am, or passive observers, I would say there are some good tendencies, namely, that interest rates aren't going to stay forever at these astronomical levels, they will come down. And that means that lending will be available on somewhat better terms, there will be some recovery in the world economy.

So, if you looked at the situation simply in terms of today's position, you might become overly pessimistic. Yet, I think it means that we have to reconsider not the institutions but reconsider how the present distribution of world surplus and deficit will get reallocated in this capital-lending process.

Representative REUSS. Mr. Fried.

Mr. FRIED. I don't think that the shrinking of the OPEC surplus in itself makes that much of a difference. I agree with Larry on this.

You could argue that the OPEC surplus represented an easy source of savings to be tapped, it was automatic saving, thus added to the world level of savings.

You could also argue, to my mind, even more strongly, that the disappearance of the OPEC surplus represents the removal of a drag on the world economy and therefore can result in somewhat higher levels of output and, in that sense, higher level of savings than would otherwise take place.

I think, in either case, the issue is the same as far as the developing countries were concerned, when the OPEC surplus was large or when we go back into the more traditional relationship of industrial countries exporting capital to the developing countries, and that is to what extent can these countries compete for savings on a world scale? And I think that the criterion for this should be, as it is in any other situation, where the return on investment is high.

And I would argue generally the return on investment in the developing countries has been—return to capital has been above average and that, therefore, these countries should be able to continue to attract capital on a very large scale, leaving aside, of course, the problems of the poorest countries, who, for technical and economic reasons, do not have access to savings on this basis.

That brings in the other part of your question, which I think is very important, will the banks be spooked, as you put it, by the Polish debt problem, the whole concern with Eastern European debt, and the general rise in the volume of debt in the developing countries.

And here I think it's essential to make a very sharp distinction between Poland, that has had negative growth for many reasons for 2 or 3 years, and the developing countries or the more rapidly advancing developing countries, who have had rather substantial levels of continued economic growth and therefore continue to demonstrate their ability to use capital effectively.

INCREASE PUBLIC LENDING TO PROVIDE CONFIDENCE IN BANKING SYSTEM

But the spooking problem is a real one, and it's for that reason that I think that it is important for the industrial world and for the United States, in particular, to make it possible for institutions like—for the World Bank and the regional banks, among others, to increase their lending at this time, because it provides confidence to the system as a whole. And second, that we should have a far different attitude than we seem to have on the issue of expansion of Fund quotas.

I don't think this is something we argue, that this is something that we should worry about, an expansion of Fund quotas, because giving the Fund more resources will result in financing adjustment and therefore postponing it. To my mind, this is very, very wrongheaded reasoning.

The Fund, as well as the Bank's, are necessary and useful for the reason that they promote adjustment, they don't postpone it. And any impairment of the Fund's ability, as well as the Bank's ability to perform this essential function does harm to us all.

Representative REUSS. Mr. Sewell.

Mr. SEWELL. Mr. Chairman, just let me add two points, a brief one. One of the developments clearly, at least in private capital markets, will be the claims put on by the now deficit, I suppose, OPEC countries. Clearly, some OPEC countries will remain in good financial shape, but a number of others will tend, I think, to move into private markets, private bank lending, to continue to finance their development program.

And I would guess, although I'm not a private banker, that they are slightly more creditworthy as they have oil, obviously.

Second, there's an aspect to this question of adjustment and dept which hasn't been alluded so far. And it's not economic, it's political.

When one looks at the major holders in the major development country debtors, beginning with Brazil and going down through Mexico, Algeria, Indonesia, Korea, Egypt, Turkey, and so on, these are all countries in which the United States has a considerable political stake, rightly or wrongly. One can argue about that. But we consider these countries important to our strategic interests for different reasons in each case.

And the question of forcing adjustment on these countries and the internal stresses and strains that it will cause, including political instability, are not to be factored out of the equation.

It's not simply a question of whether you're going to enforce financial orthodoxy and countries are going to adjust. As Mr. Fried indicated, they've already adjusted to a considerable extent anyway. It's a question of what impact this will have on Brazil, for instance, which is important to us a major trading partner, a major debtor, a major regional power, a country that's still thinking about undergoing an interesting experiment in political liberalization.

So, the political aspect to this it is terribly important that we not lose sight of.

Representative REUSS. On a related subject, Mr. Sewell. In your prepared statement, you advocated the setting up of an international safety net to help the LDC's before they get into serious financial troubles. Could you spell that out a little bit.

Specifically, to what extent are you thinking about an expansion of the existing International Monetary Fund consultation process? To what extent may you have in your mind an expansion or even privatization of the Paris Club? What kind of institutions are you talking about? What needs to be done to construct that——

Mr. SEWELL. Mr. Chairman, I'm not going to expand in great detail, because I think it's one of the issues that needs serious discussion among financial decisionmakers, particularly expansion, if that's the way to put it, of the Paris Club procedure, which tends to take place only when countries get into difficulty and therefore comes in at the last moment, with all sorts of serious problems.

I think we need some sort of anticipatory system which will enable us to flag problems before they arise and to deal with them in a variety of ways, depending upon the circumstances of individual countries. And I think this is an issue that needs serious discussion.

A historical analysis of what has gone on since the 1950's or so, with some suggestions about how that particular aspect of it could be improved is being prepared. It does seem to me that we need much more anticipation built into the system. This is not to say things are going to collapse, but we have to look forward to what is happening to enable us to avoid trouble in the future.

Representative REUSS. Thank you, Mr. Sewell.

Mr. Fried, you emphasized the importance of IDA's low-interest loans for the LDC's. The administration, in justifying its pullback on IDA, argues that private capital can very largely take the place of multilateral lending.

What do you think of that argument?

Mr. FRIED. I think that position is dead wrong, and let me explain. I believe that there is a larger role for private investment, private lending in the developing countries. I think this is the right course to take, to seek in every way to encourage an increase in those forms of capital, and for the most part the obstacles to an increase are largely technical imperfections of the market, if you wish, that prevents them. So I agree completely with that.

What I disagree with is that this can substitute for the lending of the multilateral development banks, in particular. To the contrary, I think that the hard lending of the banks are an important requirement to facilitate an increase in private flows, whether direct investment or the banks—commercial banks. I think this is demonstrated by the development of cofinancing over the past 3, 4, or 5 years and the indications that this is being pressed further in the future.

It isn't going to enable us to do this thing on the cheap. To the contrary, in the case of IDA I think what was not recognized is that IDA represents, for the most part, infrastructure in the poorest countries. Unless that is put into place, there isn't a hope of mobilizing foreign capital private in any form on any significant scale. The two go hand in hand.

So if we want to increase the flow of private capital from the industrial world to the developing world, which I think we should want, it will also be necessary to enable these institutions to expand, not to cut back on their role.

Representative REUSS. Thank you.

PROSPECTS FOR SOUTH-SOUTH TRADE

On another subject, Mr. Klein, you suggested that in view of the shortfall in North-South developments and investment in the systems, that the South should explore the prospects for enhanced South-South trade. I certainly don't dismiss that thought on the grounds that that's suggesting the poor taking each other's laundry, but what are the prospects for more South-South trade that make sense, in the sense that there is a complimentarity?

Mr. KLEIN. I think there's a lot of complimentarity in the developing world now. That does not mean th[illegible] it's the preferred way of attacking the problems, but I think circumstances are such that we should be looking for second-best solutions, and the main thing that has developed, I think, is that a number of countries have now initiated their own sophisticated industry and manufacturing activities and

if one would look, for example, at the Pacific area by itself, they would say that there are countries in that area that produce rubber and timber and oil and other basic materials, and also have a ready access to a very rich assortment of industrial materials in Australia, and simultaneously there are countries that can manufacture sophisticated electronics and heavy things in steel and transportation equipment and so on, so that you have a small model of the world economy sitting right there and there could obviously be a lot of encouragement that might take the form of capital financial assistance to get it going, that might prove to be very valuable.

Now, it doesn't have to be confined to that particular area. You could envisage a scheme like that expanding all over the developing world, and given that the developing countries are having these rather difficult times in relationship with the industrial countries, it might be to their advantage, as I say, to short circuit the industrial countries as much as possible.

Representative REUSS. Thank you.

Representative Richmond.

Representative RICHMOND. Thank you, Mr. Chairman. I'll try to be brief.

WILL THE NEW SURPLUS NATIONS TAKE OVER OPEC RECYCLING ROLE?

Mr. Klein, you feel now that OPEC will be going from a surplus position into either a balanced position or slightly opposite?

Mr. KLEIN. Actually, my own group's forecasts are that they would be in deficit, current account deficit this year, but as Mr. Fried has suggested, it's a chancy forecast.

Representative RICHMOND. That's, of course, because of the massive amount of construction they've been doing within their own countries plus the financing of the Iraqi war and such other items.

Mr. KLEIN. There are many drains. The low price of oil and the necessity to institute production controls in order to shore up the price means that the volume component is low, the price component is not rising as expected, and they are carrying on costly military ventures.

Representative RICHMOND. What will that do to the international investment market? As you know, the building boom we're experiencing in many cities throughout the United States is due partially to surplus funds.

Mr. KLEIN. Well, there still is a huge accumulated surplus from the past that's being invested around the world. That's not new funds, but that gets rolled over and reinvested, and some of it can be shifted from liquid holdings to——

Representative RICHMOND. But chances are there'll be fewer speculative office buildings being built around the United States.

Mr. KLEIN. Yes, but I think really the big thing that has happened is that the current accounts of Germany and Japan are moving into significant surplus. Now, they won't be the only countries, but they will be two striking cases. So in some respects, it removes the recycling burden from getting the OPEC money back into the world financial stream and getting the German and the Japanese holdings back into the financial stream, and that is a new set of issues.

Representative RICHMOND. I would hope one thing that can develop from the Versailles summit meeting is a commitment on the part of the Japanese to start shipping some of their capital into other countries such as our own. They clearly have surplus capital-management know-how.

Mr. KLEIN. That is happening already.

Representative RICHMOND. But I would like to see a much greater flow. Of course, that's a highly American desire. I would hope the Japanese would bring some of their capital in and build up some of our industries, the way the Germans have built up our tooling industry.

I want to ask a few more questions, Mr. Chairman. Do we have the time?

Representative REUSS. We are fine. I should, if I may, and I do, hand you the gavel so that you can take your own time. I must take off for a vote. I will thank each member of the panel for a memorable contribution from the Overseas Development Council, Brookings, and the remarkable multinational conglomerate brain trust put together by the Wharton School and Mr. Klein. What they are doing for public enlightenment is remarkable, so it isn't just today's performance that I'm grateful for.

Our hearings are about to be concluded. They have succeeded, I think, in turning up a pretty good smorgasbord of offerings for the summiteers, in terms of U.S. fiscal and monetary policy, in terms of international trade, in terms of development aid, which, if the summiteers choose to adopt them, would be a greatly desirable thing. We shall watch them closely to see how keenly they follow the advice of the witnesses before the Joint Economic Committee. So if you will take it on from there, Congressman Richmond.

Representative RICHMOND [presiding]. Two more minutes. I have to vote also.

What is your feeling about the mess we've got ourselves in on the Falklands. Clearly it was something we should have kept out of and allowed the United Nations to mediate. We're in a no-win position with either side, but we clearly made a major mistake. What's going to be the residue of this? My feeling is we're hated thoroughly in the Western Hemisphere and the United Kingdom doesn't feel we're doing enough for them, so we messed that one up.

Is that going to hurt us in the developing world, Mr. Sewell?

Mr. SEWELL. I think it's clearly going to hurt us in Latin America. Given the choice faced by the Government, that is, either siding with Argentina or Great Britain, after all of it had broken out, I mean, this was clearly an extraordinarily difficult choice.

Representative RICHMOND. No, it wasn't. This insane piece of megalomania on the part of two people who want to keep control of their governments—we should have just stayed out of it and said we think it's a great thing for the United Nations to handle.

Mr. SEWELL. I think, Congressman, there's two issues here, one of which is that the Falkland Islands is not the only piece of leftover territory floating around the world—not literally floating, but that we're going to run into that situation time and time again. And therefore, strengthening the U.N. and strengthening ways of dealing with

those issues on a multilateral basis is terribly important, because otherwise you get into that no-win kind of choice that we were in.

SOVIET GAS PIPELINE

Representative RICHMOND. Last but not least, what's your feeling on the Russian pipeline to the West. As you know, it's $16 billion of hard money we've got out of the Russians. This pipeline would give the West Europeans an alternate source of energy if and when they wanted it. I'm very anxious to see that pipeline built. How do you folks feel about it? Can you tell me in a minute, because I have to vote, too?

Mr. FRIED. I think the pipeline will go through, but we have no influence on that decision. That decision has been made. I think that decision is in our interest. I think the real security issue is not whether or not the pipeline is built, but whether the Europeans take additional action in the form of storage facilities, integrated grids in Western Europe, these kinds of measures that can give them adequate protection in case the Soviet Union should decide to use that gas for political purposes.

Representative RICHMOND. Gentlemen, I'd like to hear more from you. I have to go to vote. Thank you very much. I appreciate your coming.

The committee is adjourned.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

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